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BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

FEBRUARY 22, 1991—INCOME AND TAX TRENDS IN THE 1980's: A DECADE OF INEQUALITY

Part 3 of 5

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INCOME AND TAX TRENDS IN THE 1980'S: A DECADE OF INEQUALITY

FRIDAY, FEBRUARY 22, 1991

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Riegle, Simon, Wirth, Conrad, Domenici, Symms, Grassley.

Staff present: Larry Stein, staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; Jim Capretta, senior analyst for social security and health; and John Blazey, senior analyst for income security.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

Today the Budget Committee meets to consider the economic and fiscal background of the 1992 budget. To most Americans, the budget is an abstraction. Deficit projections, spending baselines and things of that sort don't always affect their everyday lives, so they don't pay that much attention to them.

Yet I think there are a couple of concrete things the American people want the Federal budget to reflect. They want a fair and equitable tax policy reflected in the budget. They want a budget that holds out the promise of solid economic growth and higher standards of living. They want a budget also that moves in the direction of balance and one that indicates that their government is concerned about keeping its fiscal house in order.

But where have we stood on these fronts over the past decade? Do we have a fair and progressive tax code? That is a question our panelists will answer for us today. Has the tax code been made more progressive over time? Has our economic growth been beneficial across the board to all Americans, or have just a privileged few benefitted from what growth has taken place in the economy?

Regrettably, the testimony we'll hear today, I think the majority of it, will tell us the story of steadily diverging paths of wealth during the decade of the 1980's; of income distribution that became increasingly concentrated; of wages that have stagnated; of a tax structure that acquired a regressive slant.

If there is a phrase that characterizes the decade of the 1980's, according to some commentators, it is that the rich got richer and the poor got poorer. That is probably not just an abstract concept. I suspect that it is a fact.

According to a recent Census Bureau study, the net worth of the average American family declined by 3.4 percent from 1984 to 1988. Yet the richest 20 percent of American households experienced a 14 percent increase in their net worth from 1984 to 1988. Real hourly earnings of the average American worker—and I think this is really a very telling statistic here, and I think it also tells us something about the political mood of the country and perhaps why the American public has such a sour attitude toward government and other things generally—but the real hourly earnings of the average American workers have fallen 4 percent since 1982. And bear in mind that 1982 was a recession year, the worst recession, perhaps depression, since the 1930's.

That is a 4-percent drop below the low point of the 1982 recession. So by that measure the sloganeering—in which we engage and call upon 8 years of prosperity and allude to the longest peacetime recovery in the history of the country—has somehow left the majority of American workers worse off than they were at the beginning of the decade. And I see it in my State, and hear it from the factory workers that I talk to in my State; there is a sense of betrayal, that somehow the American dream has not worked for them; that they have worked hard, but they find now in their mid-forties that they don't have the money to educate their children. Those whose children have gone on and left the home, they see their children having an even lower standard of living than they, the parents, had when they were the children's age. There is a great sense that something is awry.

In sharp contrast to the average working person, the richest 5 percent of Americans saw their real incomes rise by 45 percent in the last decade.

And the story on the tax front is no different. Between 1980 and 1990, tax rates for the richest one percent of all families dropped from about 32 percent to just over 27 percent, while tax rates for 60 percent of all American families increased.

Indeed, one witness today notes that the richest one percent of all Americans received an $84 billion tax break in 1990.

We cannot change these income and tax trends overnight, but in the long run, I think, for the economic and political stability of the country they must change. Income growth and tax fairness must be prospects within the reach of all Americans, not just those at the top of the economic pyramid.

We need to take steps to see that the American dream, that the average worker's dreams in this country—I think with some justification—for well over half a century—once again becomes a reality.

I will turn now to the distinguished ranking member for any comment or observation he wishes to make, and in view of the sparse attendance this morning will turn to the other Senators for any opening statements they wish to make.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, let me start with two remarks that I didn't plan to make, but that I'm prompted to make in a general way having listened to your remarks.

First—and I think having read some of the statements, in particular Mr. McIntyre's statement for today, I would open my remarks by making this observation about numbers and statistics—and I'm going to quote because somebody very profound, which I am not, said this, and I think he is right: "If you torture numbers long enough, they will confess to anything." That's the first point.

And secondly, I remember having seen the most current poll on American attitudes, and I am amazed. If you ask Americans what do you think about yourself, are you doing all right—interesting—88 percent say yes. But if you ask them do you think your country is on the right path, they say no.

Now, I think that is interesting, and but for this recession I think it clearly indicates that everything we see around us in the last 5 years of the decade of the eighties is prosperity—the last 5 years.

Let me suggest that the issue for me seems to be encapsulated in a number of very simple propositions at least for today. Terms such as "income inequality" and "tax fairness" have been thrown around over this past year, and I assume politically they will be thrown around until the next Presidential campaign, especially in evaluating the 1980's.

Some of this debate has what I will call a "fixed economic pie" mentality. The assumption is that we are a nation of limited potential and that we should dwell on how to split up a static level of national income, a no-growth income level.

But the real lesson of the eighties is not that. It is that sustained economic growth and job gains are the best prescription for economic prosperity for all. A job, contrary to what you hear, remains the best income policy for this country. Policies promoting economic growth are the best investment that we can make in our future.

Today, we will probably see or talk about pie diagrams that don't grow. We are going to talk about slicing up those economic pies. Politically these types of analyses are very appealing, but they distract from the real job of putting policies in place that keep the economy growing during the 1990's and later. At worst, they stifle incentives and create barriers and inefficiencies that inhibit economic growth.

I believe the lessons of the 1980's are clear. Economic growth is primary. The decade of the 1980's, once we got out of the recession, was a decade of rising prosperity because it encompassed a record-setting period of economic expansion and thus job growth. The decade of the 1980's, let me repeat, once we were out of the recession was a decade of rising prosperity because it encompassed a record-setting period of economic expansion and job growth.

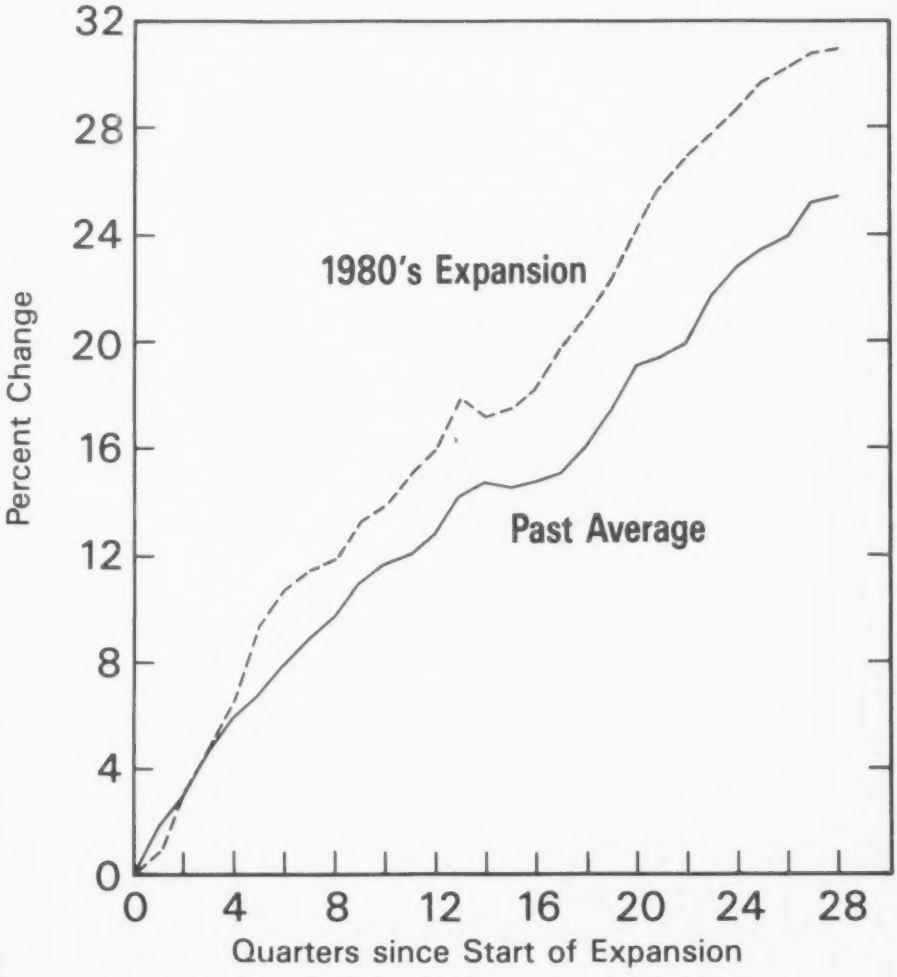
Now, since we are going to have a series of charts, I'm going to give you five very quickly. Once you got out of that recession, for the next 5 years the first chart shows that the longevity and strength of the expansion of the 1980's—and this is even longer than five years—was remarkable. GNP growth from the end of

1982 through the end of the decade was stronger than the average of previous periods. An improving economic climate—lower inflation, interest rates cut in half, productivity growth nearly doubling—all were made possible by the policies of that day.

CHART 1

Growth in Real Gross National Product

Percent Change since Start of Expansion



Source: Bureau of Economic Analysis, Dept. of Commerce

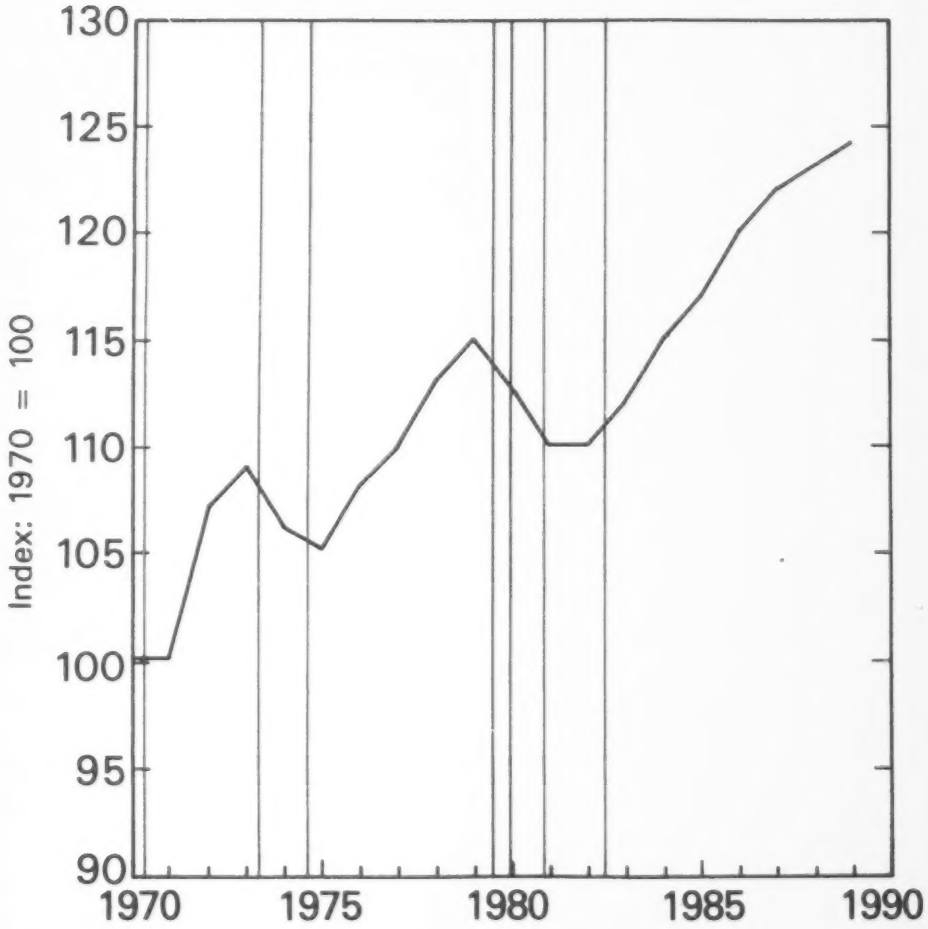
Note that real GNP growth—and this is very interesting—grew at an average rate of 3.95 percent a year, for a 31 percent increase.

Chart 2 shows that a weak economy hurts income growth. The expansion in the 1980's did much for raising incomes. Note the real income of a typical family rose 10.7 percent from 1983 to 1989, a real increase of 1.7 percent a year. The expansion of the 1980's truly did accomplish that.

CHART 2

Real Median Family Income

Index of Income: 1970 to 1989



Note: Adjusted for changing family size and CPI inflation bias

Source: Cong. Budget Office and Budget Cmte Staff Estimates

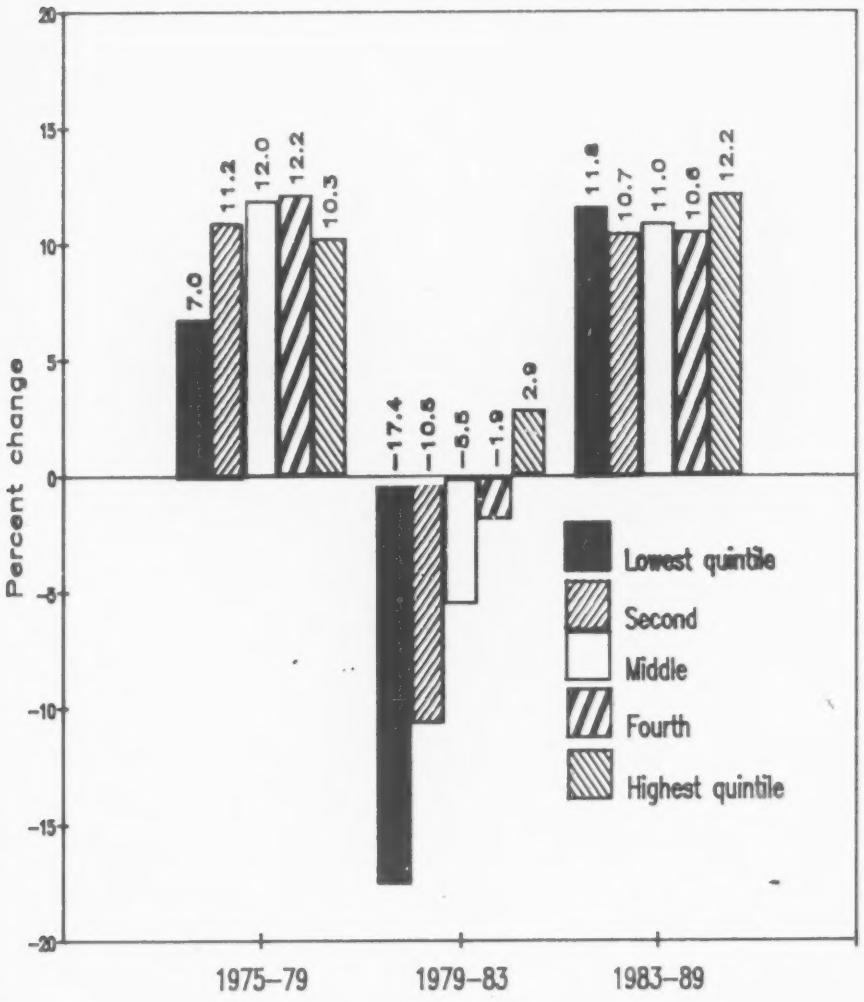
What the second chart shows is that every time you have a recession, you see the dips in income. And we will show you in a moment that if there is one thing that recessions do—and I hope the witnesses will address it—is hurt the poor more than the rich. It is not the economic growth periods that cause the inequity.

The third chart shows income quintiles. If you look at the solid bar, the lowest 20 percent, you will see that in the 5 years from 1975 to 1979, the lowest 20 percent only grew at 7 percent, the very rich at 10 percent. But look what happened in the recession. The lowest quintile went down 17.4 percent, and the richest stayed up 4.8.

CHART 3

All Income Levels Share In the Prosperity of Expansions

Percent Change in Real Family Income by Quintile



Source: Congressional Budget Office

Now, that is what most of the people talking about the decade of the 1980's ignore. Was it the policies of the 1980's that caused that, or was it the policies of the 1970's that caused that? I believe the latter.

That negative 17.4 percent impact on the poorest has to be made up. And look what happens when you finally come out of the recession. For those who now say the rich got richer and the poor got poorer, that just isn't true. What happened, as chart 3 shows, is that the rich got richer and the poor got richer. I thought that's what we wanted in the United States. The rich got richer and the poor got richer. Between 1983 and the end of the decade real family income for the lowest 20 percent rose nearly 12 percent, approximately the same rate as other income levels.

Now, what will happen, Mr. Chairman, is that those who will talk to us today will not take the last 5 years, but they will pool the recession years with the growth years, and obviously the recession was tough to get out of, but the growth period did a good job.

The second to the last chart is an interesting one. We wonder whether the 1980's encouraged a system of government transfers and taxes that significantly benefitted the poor, such as the Earned Income Tax Credit. Chart 4 shows that when all government programs are taken into account including taxes and noncash benefits, the average income of households in the lowest 20 percent of income distribution is actually $5,500 per household higher.

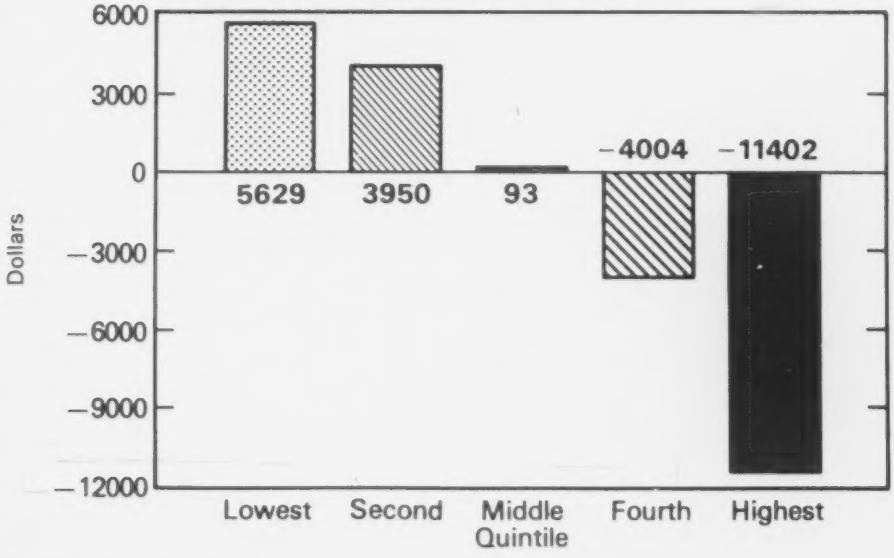
CHART 4

Redistribution Through Taxes and Transfers Benefits the Poor

Average Income by Quintile, 1989

Quintile	Definition of Income: Cash Income Before Taxes and Government Transfers	Definition of Income: Income After Taxes and Government Transfers	Difference
Lowest	$ 2,532	$ 8,161	+$5,629
Second	$13,840	$17,790	+$3,950
Middle	$26,837	$26,930	+$ 93
Fourth	$42,196	$38,192	−$4,004
Highest	$83,380	$ 71,978	−$11,402

Difference in Average Income, Before and After Taxes and Transfers



Source: Bureau of the Census

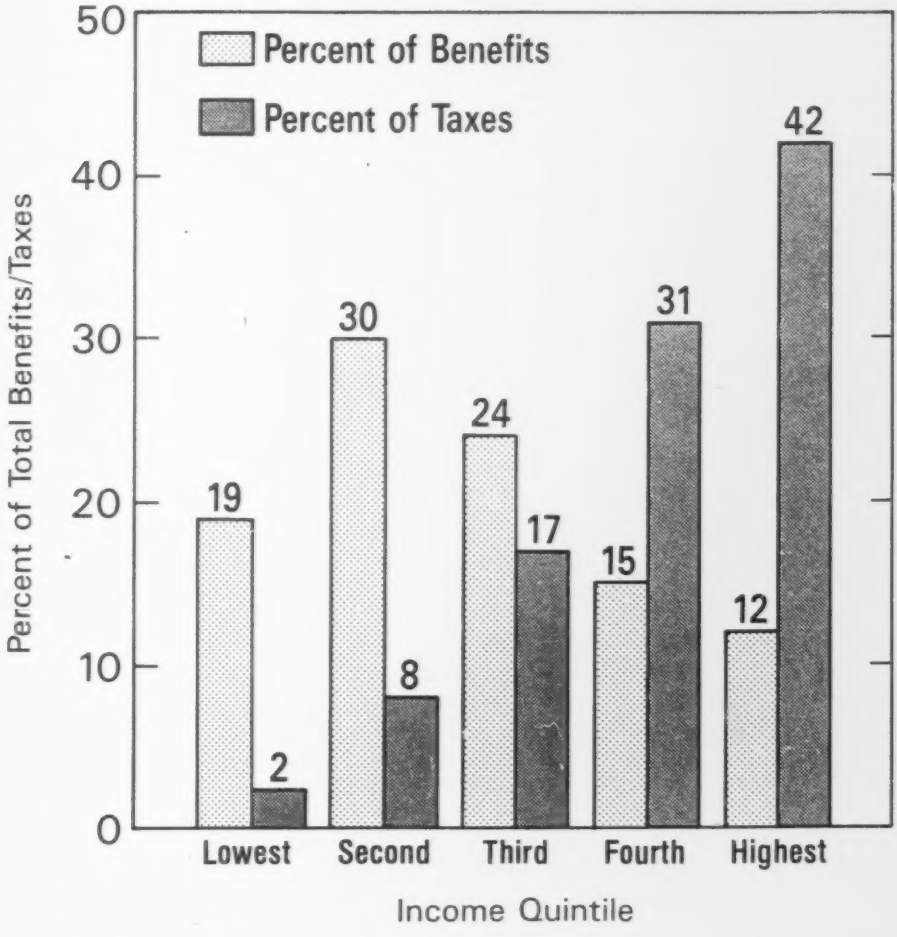
Partly in order to pay for income redistribution, to the lower half of the income scale, the government removes $11,000 from the top 20 percent and $4,000 from the next highest. For anyone who doesn't think we are doing significant amounts to try to redistribute income, that seems to me to be pretty good evidence of it.

And with regard to my last chart, I want to talk about social security because everyone is taking the social security tax and putting it into the income tax.

CHART 5

Share of Social Security Benefits Received vs. Taxes Paid by Income Quintile

(Percent of Total Benefits/Taxes, 1987)



Source: Social Security Administration

Those who benefitted most from the individual tax rate cuts of the 1980's were those at the lower end of the income distribution. Last fall's budget agreement made further changes that benefitted the lower income groups. But payroll taxes increased to finance the social security system and in many instances offset the increased progressivity.

Payroll taxes should not be viewed as regressive. Maybe some would like to call it that, but when social security benefits are factored into the program; it remains highly progressive. The lowest 20 percent of the income distribution receives 19 percent of the social security benefits and pays 2 percent of the cost. Payroll taxes were increased in the 1980's to ensure the solvency. As a result, wage earners at the low end of the income scale will continue to enjoy social security benefits that are far greater than their contributions. Note that the highest quintile pays 42 percent of the costs and gets back 12 percent. The next highest pays 31 percent and gets back 15 percent. And those who are in the most severe economic status in the country pay in 2 percent and get back 19 percent. I think that is rather progressive.

I conclude that we ought to be busy establishing policies that will (1) prevent recessions from occurring—they are the most devastating things to the poor in the country; (2) we ought to be busy finding policies that cause sustained economic growth—looking at our tax policies from time to time. This the best social policy around.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

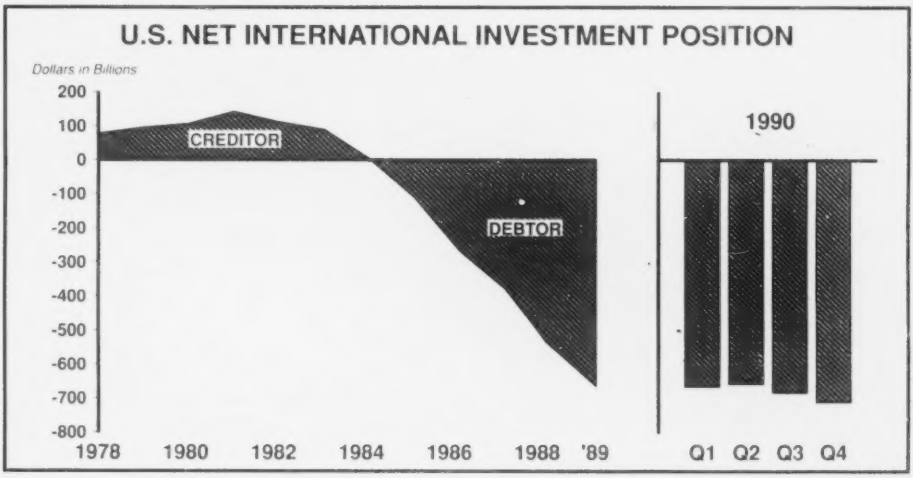
Senator RIEGLE. Mr. Chairman, I appreciate the fact that given the smaller number of members present today there is an opportunity for opening statements by all of us, and I think this is one of the most important hearings that we're likely to have because it gets into this issue of how the tax code is working. I think we have to look at it not only from the point of view of income distribution and fairness, which are the central focus of this discussion, but there are underlying factors over the period of the 1980's that also have to be looked at and I think illuminated and understood if we are going to get very far in this kind of discussion.

In the same spirit of Senator Domenici and his charts, I've got a couple charts that I'd like to put on the table today, but very particularly because I want our three panelists to get into this part of the discussion. So I do this for the sake of them as well as my colleagues on the committee.

I'm going to ask if I may to distribute a copy of a chart which you will not have seen before because it is something we've been working on and have put together in a different way.

I'm going to step down here, if I may, and I'll just take a minute on this.

With respect to the whole question of how well the U.S. economy is doing, in fact it isn't doing very well, and I wish it were. But we should not deceive ourselves with charts that say that things are fine and dandy.



This chart, which is I think probably as useful a bottom line chart as to how the national economy is working, really shows how we're doing in the context of the global economy, and that is terribly relevant. We don't have to go very far beyond the morning paper to see that Saudi Arabia is pumping $500 million into Citicorp to understand the changed nature of the world economy. But what this chart shows——

Chairman SASSER. Senator Riegle, if I could make a suggestion, I don't want to miss a word of your presentation, and if you could step over to the microphone, it would be very helpful.

Senator RIEGLE. This chart start in 1977 and goes up through 1990, the most current data that we have, it depicts in a bottom line sense America's economic standing vis-a-vis the rest of the world in terms of our creditor or debtor nation status. This is what is striking about it, this zero line that cuts across indicates that in the mid-1980's we crossed the debtor nation line and went into a deficit position. And as you can see from the slope of this line through the late 1980's and now on into 1990—of course, there is white space here, but if you were to compress this over, you would see a continuation of this plunge—we are adding international debt right now at the rate of about $1 billion every 3 days.

What is significant is that going back from this crossover point to an earlier period of time, we were a creditor nation all the way back to 1914, so we had a very good international run, until some things started to happen. Now, the tax situation is only part of it, but it is a significant part of it, and you see what starts to happen to our relative performance, and I think it is a very dangerous trend line. We are going to owe the rest of the world roughly $1 trillion in 1992.

A year ago, I asked the managing directors of one of the largest investment houses in our country what it would mean if the United States ends up owing the rest of the world $1 trillion net by 1992. And after cogitating on it for a minute, they said they didn't feel smart enough to answer the question, but they thought we'd be

stupid to find out. Nations get themselves off these kinds of trend lines; it is unwise and dangerous to stay on it. But that is one chart that I think has to be also considered in the context of those growth charts we saw a moment ago.

Table XII
Tax Burdens on Debt— and Equity—Financed Projects: 1980 and 1987

(All calculations pertain to the marginal tax burdens facing an individual investor in the top marginal tax bracket for interest income, dividends, and capital gains.)

1980 Tax Rules	All Debt Project	All Equity Project Payout Rate = 0	All Equity Project Payout Rate = .5
Pretax Corporate Earnings	100	100	100
Corporate Taxes	0	(46)	(46)
Investor Taxes			
Interest and Dividends	(70)	0	(18)
Capital Gains	0	(15)	(8)
After-Tax Income to Investor	30	39	28

1987 Tax Rules	All Debt Project	All Equity Project Payout Rate = 0	All Equity Project Payout Rate = .5
Pretax Corporate Earnings	100	100	100
Corporate Taxes	0	(34)	(34)
Investor Taxes			
Interest and Dividends	(28)	0	(9)
Capital Gains	0	(18)	(9)
After-Tax Income to Investor	72	48	48

But more specifically to tax policy, I'd like to try to just quickly put this on the table because I'd like a response and reaction to this as we go through it. We made a lot of tax changes during the 1980's, and one of the things we did during that period of time is we created a tilt toward debt financing and away from equity financing. And I don't know that we really thought about it in a deliberate way; it was one of those things that comes about through a series of changes and is in effect I think an unintended consequence.

But what this depicts here is how our tax rules were working in 1980 in terms of an investor making a decision about financing a company or building a capital structure for a company. It shows if you take an all-debt project back under the 1980 tax rules, and you look at two circumstances, what happens with pretax earnings if you pay them all out to the investor or you retain half of them in the business and only pay out half, and you then impose the tax laws, both the corporate tax laws and the individual tax laws, what the respective after tax rates of return are to the investor. And you will see that our code was relatively in balance in that respect back in 1980. In other words, an all-debt project at that period of time in terms of its after tax impact to the investors, who are principally the higher-income people, were in a rough parity—whether you paid all the income out or whether you retained half of it in the form of retained earnings.

So we had a kind of rough balance in terms of not tilting the tax code one way or the other toward debt financing as opposed to equity financing, and that is relevant because in 1989 the Japanese raised and put into their private businesses five times the amount of equity capital that we did in the United States. That is one of the reasons why we are not performing very well today in the international economy.

But then we made a series of tax changes, and the interconnection of the effect of the tax changes was that if you go back through and you structure the same model where an investor takes, as the case here, 100 units of pretax corporate earnings, and in light of the tax changes you will see that the all-debt project now has a situation where the after tax income to the investor was 72 percent, whereas if it is done all with equity, all of which is paid out in the way of earnings and half of which is retained, you see that there is a major shift in the impact in terms of how the equity investment is treated after taxes—and that's what we're here talking about, the affected tax policy—versus the debt project. And this differential, I would submit, is substantial enough, the difference between the 48 and the 72 as opposed to where we were here, that we no longer have a relatively level playing field. We tilted the playing field way off its axis.

And I would just say to Senator Domenici particularly because he's got a great concern about the leveraged buyouts and the takeovers that happened in the country—you have spoken about this as effectively as anybody in the place. What happened was we ended up with a tax code that encouraged that. So what you saw happening was high-income investors going in, emptying out the equity of companies, replacing it with debt, and a lot of that debt binge and that debt hangover is what we are struggling to try to deal with

right now. We had Alan Greenspan up in the Banking Committee a day ago, trying to explain the credit crunch, which he is not really very able to do because it is so diabolically complex, and a whole lot of it has to do with the fact that we went on this debt binge of the 1980's because of the way we structured the tax code. We went in and hollowed out the balance sheets of all these companies with the leveraged buyouts and the junk bonds and so forth, and we set ourselves up for precisely the dilemma that we have.

If you want to know where all this money went, it did not go to the people at the bottom end of the income stream. All of this balance sheet equity that was drawn out and replaced with debt went to high-income people, and they spent it, a lot of it, on consumption, whether on nice boats or nice trips or expensive educations or fur coats or whatever it happens to be. So there was a major withdrawal of equity capital out of our system—and one of the great ironies is that it helps set us up for exactly this kind of a situation that we find ourselves in internationally, where we can't compete effectively because we have tilted the tax code in a way that really works against us.

In any event, I just want to put that on the table. That's the tip of the iceberg in the way of a discussion because we could talk about this for a month and probably should. But I just wanted to put this issue out there.

Chairman SASSER. Thank you, Senator Riegle.

Senator Symms, you are next. Do you have any charts?

Senator SYMMS. Mr. Chairman, I am anxious to hear from the witnesses, so I'm going to withhold until I ask my questions.

Chairman SASSER. All right.

Senator Conrad, do you have an opening statement?

Senator CONRAD. Well, Mr. Chairman, I am glad that we've gotten into charts this morning. I think they are very revealing. I too am interested in hearing from the witnesses, and I do think at this point we should turn to them. I am eager to hear their testimony.

Chairman SASSER. Thank you very much, Senator Conrad.

Senator WIRTH. I have some overheads, Mr. Chairman. [Laughter.]

Chairman SASSER. I'm sorry, I didn't see you over there, Senator Wirth. Do you have an opening statement you'd like to make this morning?

Senator WIRTH. Not this morning, Mr. Chairman.

Chairman SASSER. All right, thank you.

I have a prepared statement for Senator Kasten to be inserted in the record at this point.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

A common perception of the 1980's is that the wealthy were the near exclusive beneficiaries of the economic expansion. Though we will hear this tax "fairness" argument from some of our witnesses, it is a view that is not supported by the facts.

The tax cuts of the 1980's ushered in the longest and strongest peacetime economic expansion in our country's history. Over 20 million new jobs were created.

All boats were lifted by the rising tide of the Reagan expansion. The only difference is that some were lifted higher than others. According to the Congressional Budget Office, in the 1980's, the top four quintiles of American earners all showed

significant real income gains—from 4.3 percent in the lower range to 31.7 percent in the highest quintile. This is a marked change from the significant decline in all five quintiles experienced under the high tax Carter administration.

The question of the lowest quintile—in which income declined by 3.2 percent in the 1980's—remains to be addressed. There is no evidence that it is the result of Federal tax policy. In fact, throughout the 1980's numerous actions have been taken to remove lower income taxpayers entirely from the income tax roles. We have increased and indexed the personal and dependency exemption, and increased the earned income tax credit. The Tax Reform Act of 1986 alone removed up to 4 million lower income taxpayers from the income tax roles by exempting more income in the lower range from taxation.

A primary problem for those on the lower end of the income scales is a poor education system. This is why I am such a strong proponent of empowerment initiatives such as education choice. This will improve quality in education by promoting competition.

An important point about statistics such as those measuring income shifts is that it is critically important what base years are used. The above numbers measure from 1980 to 1990, including the recession of the early 1980's. If the years 1983 to 1989 are used—the years of the Reagan expansion that resulted from the tax policies implemented in the early 1980's the income of the lowest quintile rose 11.8 percent, roughly equal to that of the other quintiles.

One significant point that "fairness" advocates often ignore is that the income tax cuts of the 1980's have led to the wealthy bearing a far greater portion of the income tax burden. While the average income tax payment of the wealthiest 1 percent of taxpayers rose by 30 percent between 1981 and 1987, the average tax payment of the middle and lower income groups declined 17.9 percent and 24.2 percent, respectively. In fact, by 1987 the wealthiest 1 percent paid 24.6 percent of total income taxes, up from 17.6 percent in 1981, while the lower 50 percent of income earners paid 6.1 percent of income taxes, down from 7.5 percent in 1981. The income tax system today is highly progressive. The effective income tax rate of the top 1 percent of taxpayers is 26 percent, it is 5 percent for the bottom 50 percent.

Chairman SASSER. We are very pleased to have before us this morning a distinguished panel consisting first of Mr. Gary Burtless, a Senior Fellow at the Brookings Institution. Mr. Burtless is certainly no stranger to Capitol Hill. He is frequently called upon for his advice on a number of topics, particularly social security and unemployment insurance. Mr. Burtless is an author of note; his latest book, a work on the changing structure of wages in the United States, I think is particularly relevant to the topic of today's hearing.

Mr. Burtless is a graduate of Yale; he earned his doctorate at MIT, and we are pleased to have him.

He is joined today by Mr. Robert S. McIntyre, who serves as the director of Citizens for Tax Justice, where he has been employed since 1980. Mr. McIntyre is well-known for his knowledge and expertise on many aspects of taxation, including equity in the tax system.

Mr. McIntyre has been widely published in his field, and he holds degrees from the University of Pennsylvania and Georgetown University as well as a degree from Providence College.

We are also pleased to have Mr. Marvin Kosters with us today. Mr. Kosters serves as the director of Economic Policy Studies at the American Enterprise Institute for Public Policy Research. Mr. Kosters has had a distinguished career in the field of economics, both in the public and private sectors. He holds a Ph.D. from the University of Chicago and has served in a number of capacities in the Nixon administration and the Ford administration and has brought his expertise to the Council of Economic Advisers and the Department of Labor.

Gentlemen, we are very pleased to have you here this morning, and we'll begin from my left to my right with you, Mr. Burtless, then Mr. McIntyre, then Mr. Kosters.

Mr. Burtless.

STATEMENT OF GARY BURTLESS, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. BURTLESS. Thank you very much, and thank you for the invitation to testify.

In the war of charts and colored displays, I am afraid the members of this committee are more like the allied forces in the gulf, and I am like the Iraqi army—I have to take your bombardment, and I don't have any colored charts to defend myself with.

Let me just summarize the text of my formal statement. I'll begin by mentioning some important trends in the income distribution, and then I'll describe three or four of what I take to be the principal reasons behind these trends. And finally I'd like to turn to the policy questions raised in your letter of invitation. What policies might help alleviate some of the problems mentioned and discussed so far this morning?

Let's begin with a summary of the main income trends. For most of us in this room and outside of it, average family income seems to provide a simple and understandable gauge to tell how well the economy is doing. Judged by this yardstick, economic progress in the country was once very good. Most American families could expect their incomes to grow from one year to the next, certainly over a 2- or 3-year period.

In the 1950's, for example, median family income adjusted for inflation grew about one-third; it grew about one-third again in the 1960's. It has fallen off dramatically since 1973. Median family income rose from 1947 to 1973 by 2.8 percent a year, but since 1973 it has only grown a half percentage point a year.[1] That is a drop of more than 80 percent.

Unfortunately, income gains since 1973 have been very unequal, as a number of the members have mentioned. In Figure 2[2] of my statement, if anyone has it, I compare income changes at selected points in the family income distribution. The darker bars show what happened between 1947 and 1973; the lighter bars show what has happened since 1973.

Before 1973, income growth was high for families everywhere in the income distribution, but it was strongest for families near the middle. Since 1973, income growth has slumped everywhere in the distribution, but it has fallen most sharply among families with low incomes. In fact, after adjusting for inflation, families at the 20th income percentile received no more income in 1989 than they did in 1973——

Chairman SASSER. This is which figure in your statement?

Mr. BURTLESS. Figure 2. The nice, tall bars show what the good old days were like, and the low, uneven, lighter bars show what the new days have brought.

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[1] See chart p. 42.
[1] See chart p. 43.

And remember, these income gains are over two full business cycles, from 1973 to 1979 and from 1979 to 1989. Strangely enough, even though the overall economic situation has improved in the 1980's—and I think it has—it has gotten even worse for families with moderate and low incomes. In the third figure [1] of my statement, I show the same kinds of income gains, but divided over different periods—from 1973 to 1979 and from 1979 to 1989.

Families below the 60th percentile have had income growth that is even slower since 1979 than it was during the economic malaise of the late 1970's. For families in the bottom quarter of the distribution, incomes have actually fallen since 1979. Households in the top one-fifth of the distribution have seen their income situation improve; the malaise is over for the affluent.

When the size of the economic pie stops growing, everybody is more concerned about the relative size of his or her own slice in the pie——

Chairman SASSER. Let me ask you one question if I might interrupt for just a moment, Mr. Burtless.

Mr. BURTLESS. Go right ahead.

Chairman SASSER. You are talking about per family or per capita income here?

Mr. BURTLESS. This is per family income.

Chairman SASSER. Do these figures take into consideration the growth in two wage earners per family?

Mr. BURTLESS. This is simply the official census series on what median income has been, adjusted for the change in prices, measured I think in a way that is even-handed. The trend in per capita income in the United States shows roughly the same trend. There has been a drop—some people think that income statistics on per capita income paint a much rosier view of what has happened to the economy than do these family income statistics, and to some degree they are right. Per capita personal income, however, rose faster before 1973 and substantially so than it did after.

Per capita income rose 2.7 percent per year from 1947 to 1973, and it has only grown .7 percent a year since 1973. So the trends are similar when we look at per capita income.

The Congressional Budget Office has done some studies trying to adjust these per capita numbers for family size and so on, and their conclusion is that the inequality of per capita income has also risen and especially in the 1980's.

So this relative trend I'm showing here is true both for families and for individuals.

Senator DOMENICI. Mr. Chairman, could I ask a clarifying question?

Chairman SASSER. Go right ahead.

Senator DOMENICI. Mr. Burtless, in my statement, I used the best evidence from CBO on family size. And we also included in-kind transfers and distributions from the Federal Government, and post taxes also. That is not included in your figure 2, is it?

Mr. BURTLESS. That's right. That's exactly right. Now, the per capita income series should get rid of that problem I think because

[1] See chart p. 44.

per capita income includes these in-kind benefits appropriately. And that is one of the explanations for the difference in the trends between per capita income and family income. You are exactly right.

If you include in-kind income, there was a great deal of income growth at the lower part of the distribution from about 1965, when the government began introducing a lot of important means-tested in-kind benefits, and 1977 or 1978, when in-kind programs essentially reached maturity.

Since 1978, really, I don't think in-kind benefits have increased very much because 90 percent of what the government pays out in the form of benefits to low-income families has been in the form of these in-kind benefits since 1979. It can't go up much higher than that. We still pay out some in cash, but we can't pay out too much more in in-kind benefits.

Senator DOMENICI. Excepting I would say we have begun to make a rather deliberate use of the earned income tax credit for the low-income workers, and that is getting very big. In fact, the last one had $15 billion in it, at the summit; it all went into that new tax cost that we had to make up with new taxes. So that is a big change in what they have to spend, isn't it?

Chairman SASSER. If I could make a suggestion, Senator Domenici, why don't we let the witness finish his statement, and then we can get into questions, and if we want to contest his methodology at that time, we can do it.

Senator DOMENICI. I agree.

Chairman SASSER. Proceed, Mr. Burtless.

Mr. BURTLESS. Well, I don't regard these as contesting; these are just good discussions, I think.

These statistics ignore the effect of taxes, and of course, tax credits, as you suggest. But they also ignore the effects of social security taxes, which have disproportionately affected wage earners with incomes below $50,000. So I'm not sure that the Earned Income Tax Credit has risen much more than the payroll tax burden on these low-income families.

Well, let me look for a moment at figure 4,[1] which shows a nice tabulation of what happens to inequality. This addresses something that Senator Domenici said in his opening statement. The two lines in that diagram essentially show how well families at the top of the U.S. income distribution are doing relative to those at the bottom. It is the number of dollars that people in the top 5 percent or top 20 percent of the income distribution receive relative to the average incomes of people in the bottom 20 percent. And as Senator Domenici pointed out, prosperity is very good for the less affluent.

The ratio of income of the top people goes down relative to the incomes of the less affluent during expansions. But the thing that is interesting in this diagram is that even though the ratio of income at the top to the bottom jumped in the most recent recessions, as it has in past recessions, during the economic recovery of

[1] See chart p. 45.

the 1980's the relative incomes of the affluent have continued to grow, and that is unusual for an economic expansion.

Income growth has slowed down for one main reason. The pace of productivity improvement has dropped, and this has dramatically slowed wage growth. The reasons for the productivity slowdown are not fully understood by me or by any of my colleagues, but I think the consequences are painfully obvious to any American who draws a paycheck. The purchasing power of their wages has been rising slowly, if at all, since the early 1970's. Because most American families depend on their paychecks for most of their incomes, this means that family incomes have not gone up very fast.

Per capita income has continued to climb since 1973 and since 1979, in spite of the miserable trend in wages, but mostly because the percentage of the population that is of working age and that is at work is rising.

In terms of employment, the U.S. economy has prospered, but in terms of the standard of living it offers to the average worker or moderate income worker, I'm afraid the economy continues to be stuck in neutral.

But why has inequality jumped so much? Forgetting the trend in average wages, why has the gap between wages risen so much?

Well, income inequality has grown for a number of reasons; I'd like to talk just about a couple of them. First of all, there has been a steady increase in the percentage of single-parent families, and that increases the percentage of families with very low incomes. Second is the growing disparity in wages especially among men. What has happened to wages?

Figure 5[1] in my diagram shows what has happened at selected points of the wage distribution for men. It shows what has happened since 1967 and what has happened since 1979. The numbers in this graph show clearly how inequality is rising among men, especially since 1979. Since reaching a peak in 1973, real annual earnings at the 20th percentile of the wage distribution have fallen one-fifth; earnings at the 40th percentile have fallen one-tenth.

The news for less-skilled men is actually even worse than is suggested in this picture because their employment situation has deteriorated; in other words, they are more likely to be unemployed today at a given level of unemployment than they were even in the late 1970's, and their labor force participation rate has fallen off.

So the situation is actually even worse for the low-income men than is shown in this diagram.

Now, what causes these growing gaps in wages? The changing industrial mix has contributed, but the evidence shows that this contribution is small. The size of the job loss in good industries explains a small part of what is happening to wage inequality. Most of the jump in inequality in wages has happened within the goods-producing sector and within the service-producing sector, within all the industries in our economy.

Most of these trends can be explained if we assume there has been a growing demand for skilled workers and a declining demand for the less skilled. This occurred not so much because there has

[1] See chart p. 46.

been a shift in the level of demand in different kinds of industries, but instead because in all industries employers are changing their production methods in a way that requires a more skilled work force than ever. And this raises the gap between the less skilled workers and the more skilled workers in the earnings distribution.

So less skilled men have suffered the most acute income losses. The problem they face is not a surplus of bad jobs, as is widely touted in the press, but it is a surplus of less skilled workers just like themselves in a labor market that now does not reward brawn without skill.

I have suggested to journalists that disadvantaged workers would actually be better off if the economy produced more unskilled jobs, more bad jobs, because with more employers competing for their services, unskilled workers could earn higher wages.

OK. In contrast to the situation for male earners in our country, the situation for women has continued to improve. Wages are up across the entire income distribution, and they are not up much faster among high wage women than among low wage women.

Now, unfortunately, it turns out that the labor market gains of women have not been translated into greater equality of household income. Many of the recent gains appear to have been enjoyed disproportionately by women who are married to affluent husbands. Women who earn good wages are now much more likely to be married to men with good wages. As women increase their employment and earnings, this trend has tended to push up the gap between affluent and less affluent families.

I left for last changes in the government tax and transfer policy. This is the only factor that is under the direct control of Members of Congress, so of course they are interested in this subject. Policy changes contribute in a measurable way to growing inequality in the 1980's. Governments at every level tended to curtail public assistance and jobless benefits, which are forms of income disproportionately received by families in the bottom fifth of the distribution.

At the same time, payroll taxes were allowed to rise, driving up tax burdens on workers with moderate incomes. Income taxes were cut, but I think any dispassionate analysis would have to conclude that taxes were cut in a way that especially favored high income families.

Tons of ink have been spilled in the debate over these policies. My interpretation is that government policy played a relatively minor direct role in the trend toward greater inequality. Economic and demographic developments were much more important than were the government reforms of the early and mid-1980's in explaining why the affluent have been prosperous and why the wages of less skilled workers have fallen.

Having said that, I think even if the roll of government policy were relatively small compared to these other economic and demographic trends, it is deplorable that government policy should have played any role at all in making what is a bad situation even worse. It should have been possible to reform public assistance and the tax code and jobless pay in a way that did not reduce the share of income received by the bottom fifth of families.

Other industrialized countries have faced the same kinds of economic and demographic trends. For example, immediately to the north, Canada also has a rise in single-parent families and has a growing gap between the wages of the well-paid and the less well-paid. But in Canada poverty rates have fallen, and income inequality has been reduced at the same time that these two things have gone up in our country.

Everyone agrees that it is desirable to lift the rate of wage growth. I agree with Senator Domenici it is a very good thing to do, and it is the best long-term policy to improve the situation. But many of us also think that action is urgently needed in the case of low wage workers. For these workers, wages are not just stagnant; they are falling.

One prominent proposal to achieve some improvement is to trim the social security payroll tax. By reducing the payroll taxes over the next 10 or 15 years, we could give an immediate boost to the incomes of moderate income families without threatening social security benefits in the short term.

But this proposal is fatally flawed. Unless the government's revenue losses are offset by an increase in other taxes, a payroll tax cut would simply raise the Federal deficit. In the long run, this policy represents a serious threat to the well-being of workers even if it raises their net incomes in the short run.

Productivity and real wages can eventually be improved by boosting the share of national income that we devote to investment. But this can occur I think only if the government reduces its claim on the pathetically depleted share of national income that is private savings. On the grounds of equity, I think it is defensible to argue the payroll tax should be trimmed. But cutting the tax without doing anything else to sustain government revenues will simply hurt workers in the long run by reducing the share of national income that goes to investment.

I was asked when preparing my testimony to address the issue of means-testing benefits. That is part of the President's budget proposal. One way to reduce inequality is to cut the transfers that currently go to affluent families. The biggest of these transfers is social security and medicare. A sensible and fair way I think to reduce the net cost of these benefits is to subject to income taxation all net benefits that people receive under social security in excess of the payroll contributions they have made. This would change the tax basis of social security so it is just the same as our taxation of private pensions and so it is the same as our taxation of unemployment compensation.

If you wanted to go a bit further you could tax as ordinary income the net subsidy that people receive under the medicare program, although I think this is much more problematical from the point of view of administration and from the point of view of equity because we permit workers to get untaxed health plan benefits, so it would seem unfair to tax the health benefits that we give to the elderly.

But I oppose going any further in curtailing social security and medicare for the affluent. I am a little mystified by the proposal of conservatives and liberals who would like to set income eligibility limits on these kinds of benefits. It seems to me their political pop-

ularity and their logic depends on them being universal programs. So I would really oppose that kind of a change.

The most efficient way of improving the well-being of poor workers is to raise the benefits they can receive under the Earned Income Tax Credit. I am very happy that since 1985 Congress has liberalized this benefit, but I think in view of the deteriorating position of less skilled workers and more poorly paid workers, greater liberalization should be possible. As a share of national revenues, the EITC is really quite a small program today, and it would help offset some of the——

Chairman SASSER. Mr. Burtless are you nearing the end of your testimony?

Mr. BURTLESS. Yes; let me just make one point.

In the long run I don't think tinkering with the tax and transfer system is the way to go. I think we should try to boost the earnings of everyone, especially people at the low end, and this I think means reforms in schooling and in private sector training of the work force.

Thanks a lot. I'm sorry I went over.

Chairman SASSER. No; it is very interesting and informative testimony. Thank you very much.

[The prepared statement of Mr. Burtless follows:]

TRENDS IN THE DISTRIBUTION OF EARNINGS AND FAMILY INCOME: EFFECTS OF THE CURRENT RECESSION

Testimony for the
Senate Budget Committee

February 22, 1991

by

Gary Burtless[1]

Family Income Trends

Public interest in the income distribution is relatively recent. Over most of the post-war era Americans have been far more interested in the growth of income than in its distribution across persons or families. Median or average family income seemed to provide a simple and reliable yardstick by which to measure the overall performance of the economy. Economic performance, judged by this yardstick, was at one time quite satisfying. For many years, the average American family could reasonably expect rising real income from one year to the next -- not in every year, of course, but in most years.

During the 1950s, for example, median family income adjusted for inflation rose 34 percent. In the next decade, median income rose another 34 percent. With incomes rising this fast, few people (and even fewer politicians) bothered to inquire very closely into the distribution of incomes around the median.

The nation's experience since the early 1970s has been less satisfying. Income growth fell off dramatically starting in 1973, whether measured by average or median family income. (*See Figure 1.*) From 1947 through 1973, median income rose nearly 2.8 percent a year; since 1973 it has grown less than 0.5 percent a year.[2] Average family income has risen a bit faster than that

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[1] Senior Fellow, The Brookings Institution, Washington, D.C. I am grateful to Suzanne Smith of Brookings for providing exceptional help in preparing this testimony. The views expressed are solely my own and should not be ascribed to the staff or trustees of the Brookings Institution.

[2] To calculate real incomes I have deflated incomes using the Bureau of Labor Statistics' CPI-U-X1 price deflator series for the years 1967-1989. For years before 1967, I assumed that consumer prices changed at the rate implied by the official CPI-U series. For a variety of reasons, the CPI-U series probably overstates the true rate of inflation between 1967 and 1983.

because families near the top of the income distribution have enjoyed much faster income growth than families near the middle.

The differing rates of income growth are shown in Figure 2, where I compare income changes at selected points of the family income distribution. The darker bars show the average rate of annual income growth between 1947 and 1973; the lighter bars show annual income changes between 1973 and 1989. The five sets of bars show trends in income growth for families at five different points in the income distribution, the 20th, 40th, 60th, 80th, and 95th percentiles of annual family income. Before 1973 income growth was rapid for families everywhere in the distribution, but was strongest for families near the middle. Since 1973, income growth has slumped everywhere in the distribution, but has fallen fastest among families with low incomes. In fact, after adjusting for inflation, families at the 20th income percentile received no more income in 1989 than they did in 1973. For these families, income growth ceased in the early 1970s.

Social scientists and policy-makers are more concerned about the income distribution today than they have ever been. The reasons for this are simple. When the size of the economic pie stops growing, every person is more concerned about the relative size of his or her own slice. Moreover, the relative size of each slice has changed markedly over the past decade. In Figure 3 I have tabulated average annual income changes in two recent periods, 1973-79 and 1979-89. In the late 1970s, income growth was slow for all income groups. But at least income grew, even among families near the bottom of the distribution. Since 1979, income growth has partially recovered -- but only among families in the top quarter of the distribution. Families near the middle of the distribution continue to receive only small income gains, and families near the bottom have been losing ground. The long economic recovery of the 1980s produced very unequal gains across the income distribution.

The effects of these trends on the income distribution are documented in Table 1. Over the last twenty years the share of all income received by the richest one-fifth of families has jumped 4.0 percentage points, to 44.6

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percent, while the share received by the poorest one-fifth has fallen one percentage point, to 4.6 percent. The income shares of families in the second and third quintiles also fell, reaching the lowest levels since reliable income statistics began to be collected. These shifts in the income distribution may not appear sizable, but they reversed trends that had prevailed over the much of the post-war era.

To illustrate this point, I have calculated the ratio of average income received by families in the top part of the distribution to the average income of families at the bottom (*see Figure 4*). The lower line in Figure 4 shows the ratio of average income received by families in the top 20 percent of the distribution to the average income received by families in the bottom 20 percent. This ratio has ranged from a low of 7.2 in 1968 to a peak of 9.7, which was attained in 1989. Stated another way, in 1989 the average family in the top 20 percent of the income distribution received $9.70 for each $1.00 received by an average family in the bottom 20 percent.

The higher line in Figure 4 shows the ratio of average income received by the top 5 percent of the families to average income received by families in the bottom 20 percent. This ratio has ranged from a low of 11.0 in 1967 to a high of 15.6, which was also attained in 1989.

Until the 1980s, inequality tended to rise in recessions and fall in economic recoveries. As in previous recessions, inequality jumped during the two recessions after 1979. But unlike previous recoveries, the 1983-89 recovery did not cause family income inequality to fall. Instead inequality rose, reaching a new post-war high. If the current recession follows past patterns, we should expect that family income inequality will jump even further over the next year or so.

Sources of Recent Income Trends

Some observers argue that family income statistics reflect too bleak a picture of recent economic progress. Since the late 1960s average family size has declined, so the real income needed to support an average family has fallen. In addition, a greater fraction of income is received by individuals

who do not live in families. This is because the number of unattached individuals has risen faster than the number of families and because unattached individuals have enjoyed faster income growth than families.

Both objections represent valid criticisms of average or median family income growth as the *sole* yardstick of economic progress. Per capita personal income has risen faster than median and average family income since 1973. Nonetheless, per capita income rose more slowly after 1973 than it did earlier in the post-war period.

Income growth has slowed down for one main reason: The pace of productivity improvement has declined. The reasons for the productivity slowdown are not fully understood, but the consequences are painfully obvious to most Americans who draw a paycheck. The purchasing power of their wages has been rising slowly, if at all, since the early 1970s. Because most American families and unattached individuals rely heavily on wage earnings to support themselves, the anemic rate of wage growth has meant that living standards for most working people have suffered. Per capita income has continued to climb, notwithstanding the miserable trend in wages, because the percentage of the population that is of working age and at work has grown. In terms of employment, the U.S. economy has continued to prosper. In terms of the standard of living it offers to workers, the economy continues to languish.

Not only are average living standards rising much more slowly than in the past, but the distribution of living standards is growing more unequal. In the previous section I presented evidence on trends in family income. Analysts in the Congressional Budget Office have found persuasive evidence of rising inequality when unattached individuals are included in the analysis and when proper allowance is made for the relative size of all American households. Individuals and families who began the decade of the 1980s with relatively little income ended the decade with even less. People who began the decade in affluence ended it more affluent than ever. I should emphasize that this pattern has not been an enduring feature of U.S. economic progress. From the end of the Great Depression until the beginning of the 1970s, prosperity among

the poor, rich, and middle class generally proceeded at the same pace. The poor and middle class, in fact, prospered *more* than the most affluent during this long economic upswing.

Single-parent households. Though inequality has grown for a number of reasons, I would like to mention four main reasons here. First, and least surprising, is the steady rise in the fraction of all households headed by a single parent. Since a one-parent family usually has only a single adult capable of earning wages, and since that adult seldom can earn as much as the primary earner in a two-parent family, the family will be severely handicapped in the race to earn income. Indeed, the poverty rate among single-parent families has remained relatively constant (and extremely high) over the past several decades, principally because so few single parents have the capacity to earn good wages. The swelling number of one-parent families is not a recent phenomenon, however. It has been a part of the American demographic scene since the early 1960s.

Growing wage inequality among men. A second source of rising inequality is the growing inequality in the distribution of wages, especially among 25-64 year-old men. In many people's minds, this trend is linked with the disappearance of "good" middle-class jobs. According to a popular view, the bulk of American wage earners once worked in offices and on factory assembly lines, earning enough to feed, clothe, and shelter their families in reasonable comfort. A growing proportion now work in fast food restaurants, theme parks, and other low-paying service industries where they cannot earn enough to achieve a middle-class living standard. According to this view, instead of making real products like cars or steel, the typical modern worker flips burgers or sweeps the office floor, producing too little to justify a good wage. There are serious problems with this view, as I argue below, but it accurately captures the popular feeling that average workers have been ill-served by recent labor market developments.

One way to see what has happened to the distribution of wages is to calculate the trend in earnings at selected points in the earnings

distribution. This calculation can be performed back through 1967 using the Census Bureau's Current Population Surveys. Figure 5 shows trends in inflation-adjusted annual wages for male workers aged 25-64 at five points in the earnings distribution over the period from 1967 to 1987.[3] The graph shows annual wage gains among men in two different parts of that period, 1967-1979 and 1979-1987.

Data in the figure show clearly that inequality is rising among men. In the period 1967-79, real annual earnings among men above the 80th percentile rose 1.8 percent a year. For the worker at the 20th percentile, earnings rose just 0.4 percent a year. Real earnings growth dropped sharply for workers over the entire distribution from 1979 to 1987. Wages rose only 0.5 percent a year for the worker at the 95th percentile. But real earnings actually *fell* 0.9 percent a year for a worker at the 40th percentile, and 2.0 percent a year for a worker at the 20th percentile. Since reaching a peak in 1973, real annual earnings at the 20th percentile of the wage distribution have fallen 20 percent and earnings at the 40th percentile have fallen 10 percent. By contrast, real earnings at the 80th and 95th percentiles have risen 6 and 8 percent, respectively. Inequality is up, and the share of men with wages near the middle of the wage distribution is down.

The tidings for economically disadvantaged men are even worse than implied by the statistics shown in Figure 5. Not only have these men found it harder to earn good wages if they hold a job, they have found it increasingly difficult to find a job at all. It is true that overall unemployment moderated in the late 1980s. But for men with limited skill and education, unemployment remained well above levels they had experienced as recently as the late 1970s. Moreover, many of these men have become so discouraged by poor job prospects that they have left the labor market altogether. Labor force participation rates among relatively disadvantaged men fell sharply over the 1980s in comparison with participation rates of better skilled and educated men.

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[3] These wage developments are examined closely in the essays in Gary Burtless, ed., *A Future of Lousy Jobs? The Change Distribution of U.S. Wages* (Washington, D.C.: The Brookings Institution, 1990).

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Employment and earnings losses were especially severe among younger less-skilled workers. Figure 6 shows trends in the relative earnings of two broad classes of male workers, defined on the basis of their relative educational attainment. In the figure I have tabulated the ratio of annual income received by men with four or more years of college relative to the income received by men with one to four years of high school education. For example, the darker bar for 18-24 year-old men shows that in 1978, men with a college education earned about 20 percent more than men of the same age with just a high school education. By 1987, the college earnings premium had jumped to nearly 60 percent. Among men under age 44 there was a similarly sharp rise in the payoff to a college education. At older ages, the college premium rose, but by a far smaller amount.

Other economists have discovered equally impressive gains in the payoff to workers with more measurable skill. It is also likely that some of the increase in the inequality of earnings is associated with a higher payoff to tangible but hard-to-measure skills that are not reported on Census surveys.

The changing industrial mix has also contributed to rising wage inequality, though the evidence suggests that this contribution has been small. Jobs in "good" industries are indeed disappearing, but the size of the job loss explains only a very small part of the jump in wage inequality since 1979. Most of the jump is explained by rising inequality *within* U.S. industries, both in the goods-producing and service-producing sectors.

Many of the trends in male wages and employment can be explained if there has been a growing demand for skilled workers and a declining demand for the less skilled. This has occurred not so much because there has been a shift in the level or distribution of demand across different kinds of industries, but because companies and industries have attempted to change their production methods in a way that requires a more able and skilled work force. Because skilled workers remain relatively scarce, their wages have been bid up, raising the gap between them and workers with lower educational attainment.

Less skilled men have suffered from this shift in two ways. Their

earnings have fallen compared with the wages received by better educated and more skilled men, and their joblessness has risen. The problem they face is not a surplus of bad jobs, as widely assumed, but a surplus of less skilled workers in a market requiring more skill than ever. Ironically, their labor market position could be improved if the economy produced *more* not fewer jobs requiring limited skill. Their wages might then be bid up and the wage gap with more skilled workers closed.

Earnings and marriage patterns among women. In contrast to developments among men, labor market trends for women are quite hopeful. Annual earnings are up across the entire female earnings distribution; they are not rising much more slowly at the bottom of the distribution than they are at the top. After decades of disadvantage in the labor market, women are evidently making up for lost time.

Unfortunately, the labor market gains of women have not been translated into greater equality of household income. Many of the recent gains enjoyed by women have evidently been concentrated among women who are married to affluent men. This is a third development that has tended to push up family income inequality in the 1980s. In a recent analysis of women's earnings, I found that wage rates among women in the top 20 percent of the family income distribution grew at a rate of 2-1/2 percent a year after 1979. Among women in the middle 20 percent of families, wage rates grew at just 1/2 percent a year. Women in the bottom 20 percent of families had wage rates that *declined* nearly 1 percent a year.[4] Although these trends could mean that affluent women have flourished in the labor market, it is more likely that they mean something quite different. Women who earn high wage rates are now much more likely to be members of affluent households, that is, married to well-paid spouses. As women increase their employment and earnings, this will tend disproportionately to push up the incomes of the most affluent families, widening the gap between rich and poor.

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[4] Barry Bosworth and Gary Burtless, "Effects of Tax Reform on Labor Supply, Investment, and Saving," (Washington, D.C.: The Brookings Institution, 1991).

Tax and transfer policy. I have left for last an explanation of inequality that is often first in the mind of journalists and public policy makers who think about the income distribution: Changes in government tax and transfer policy. Since this is the only factor over which policy makers exercise direct control, it has recently become the focus of intense political debate.

Public policy changes contributed in a measurable way to growing inequality during the 1980s, as analysis by the Congressional Budget Office has shown. Early in the 1980s, governments at every level tended to curtail public assistance and jobless benefits, which are disproportionately received by poorer families. At the same time, payroll taxes were allowed to rise, driving up tax burdens on workers with low to moderate incomes. Income taxes were cut in a way that disproportionately favored high-income families and households with capital income while conferring only limited benefits on the less affluent.

If there had been no other developments in the income distribution, these changes in government policy would be worth the tons of ink spilled in writing about them. But careful analysis of distributional trends shows that government policy played a relatively minor direct role in the trend toward greater inequality. The share of total income received by families in the top fifth of the income distribution rose 2.9 percentage points in the 10 years after 1979 (*see Table 1*). Tax policy played no direct part in this rise, because tax payments are ignored by the Census Bureau when it calculates the share of income received by each quintile. Transfer policy played a role, but only a minor one, because transfers represent a small share of the income received by the top 20 percent of families. It should be obvious that underlying economic and demographic developments were far more important than direct government policy in explaining the swelling incomes of the affluent and the shrinking wages of less skilled men.

But even if the role of government policy was smaller than sometimes suggested in the press or Congress, I regard it as scandalous that government

policy should have played any role at all in making a bad situation even worse. While reform in public assistance and unemployment insurance was probably long overdue at the beginning of the 1980s, it should have been possible to reform and improve these programs without reducing the share of national income received by the poorest one-fifth of families. By the standards of other industrialized countries, the share of income received by the poorest quintile of American households was already quite low at the beginning of the 1980s. Economic and demographic developments in the 1980s would depress the share still more. It is not easy to understand why the national government would find it desirable to reduce that share even further.

It is also worth noting that other industrialized countries facing similar economic and demographic trends have not experienced the spurt in inequality we have witnessed in this country. Canada, for example, has seen wage inequality rise and the number of single-parent families climb. Yet government policy tended to offset rather than reinforce the effects of these developments on the income distribution. The Canadian poverty rate has declined and family income inequality fallen over the same period that U.S. poverty and inequality rose. In large measure this stems from the fact that the national and provincial governments in Canada have strengthened rather than curtailed programs to help single-parent families and the jobless.

Policy Responses

Everyone agrees that it is desirable to lift the rate of wage growth. Many would also agree that action is more urgently needed in the case of low wage workers, where wage changes have been negative rather than positive for most of the past two decades.

Social security payroll taxes. The most prominent proposal to achieve this goal is to trim the social security payroll tax. Social security is currently accumulating large operating surpluses. The tax that largely finances these surpluses is imposed solely on earned income below about $55,000 a year. It is widely felt that this tax is regressive. (In fact, CBO analysis suggests it is regressive only in comparison with the corporate and personal

income tax. Other federal, state, and local taxes are far more regressive than the social security payroll tax.) So long as social security surpluses are being used to finance non-social-security federal spending, it is thought to be unfair to impose high payroll taxes on workers. By reducing the payroll taxes over the next 10 or 15 years, when the surpluses are expected to be accumulated, we could give an immediate boost to the after-tax earnings of hard-pressed workers.

This proposal is fatally flawed by a simple fact: Unless the federal government's revenue losses are offset by an increase in other taxes, a payroll tax cut would simply raise the federal deficit. In the long run, this policy represents a grave threat to the well-being of workers, even if it raises their incomes today. National saving -- the share of national income that we collectively set aside for investment and future consumption -- fell sharply in the 1980s. This occurred both because of reduced private saving and because of larger federal deficits, that is, higher government *dissaving*. The reductions in national saving were translated into reduced levels of spending on capital investment. Productivity growth during the 1980s and early 1990s has almost certainly been affected by this development.

Productivity and real wages of workers can eventually be improved by boosting the share of national income that is devoted to investment in capital plant and equipment. And the level of plant and equipment can be raised over the next decade only if the nation withholds a greater percentage of national income from current consumption and devotes it instead to new investment. This can occur if the federal government makes a smaller claim on the nation's pathetically depleted pool of private savings. It is hard to see how this will occur if the Congress simply reduces revenues from the payroll tax without taking any other offsetting action, such as raising the personal or corporate income tax.

On the grounds of equity, it is certainly defensible to argue that the payroll tax should be reduced. But the short-run equity gains would be wholly offset in the intermediate and longer terms if increased government dissaving

is permitted to eat up an even larger fraction of the nation's private saving.

Means-testing benefits. Another way to reduce the growing inequality of incomes is to reduce government transfers to the most affluent. The most important transfers received by the affluent are social security and medicare. Congress took a first step in limiting benefits to the affluent elderly in 1983 when it imposed taxes on one-half of social security for families with gross incomes above certain thresholds. It could logically extend this reform by subjecting to income taxation *all* social security benefits in excess of payroll tax contributions. This would put social security benefits on the same footing as unemployment compensation and employer-sponsored pension benefits.

This is the reform I favor if Congress seriously wants to limit net transfer benefits to the affluent. It is certainly fair, and it represents sound tax policy.

Congress attempted to take a second step in limiting transfers to the affluent elderly with its funding scheme for the ill-fated catastrophic care insurance plan. High-income elderly families would have been required to pay premiums tied to their taxable incomes. Even though their total premiums under the plan were far smaller than the net subsidies such families receive for Part A and Part B Medicare benefits, the affluent elderly were bitterly opposed to the plan. I suspect that any proposal to limit Medicare subsidies to the affluent elderly will meet the same political fate as the catastrophic care plan.

The fact is that social security and Medicare are the two most popular programs administered by the federal government. The public overwhelmingly supports the programs, even though many younger workers are skeptical that they will ever draw benefits. Also, contrary to the apparent belief of many politicians, the payroll tax that finances these programs is not especially unpopular. Since tax payments are directly tied to benefits paid out in a popular program, most taxpayers accurately perceive that limiting the tax will also limit the benefits. Since they approve of the benefits, they do not resent the tax that finances them.

The popularity of the programs is tied in an important way to their universality. Every 65-year-old, whether prince or pauper, can collect benefits under Medicare. Every wage earner contributes to the programs, and payments under social security are directly tied to the earnings on which contributions were assessed. Given the popularity and perceived fairness of the programs, I am somewhat mystified by the proposals of liberal and conservative critics, who wish to fundamentally transform social security and Medicare by imposing eligibility limits tied to family income. It seems to me sensible to tax as ordinary income the *net subsidy* received by families under the program. But any greater means-testing of benefits would undermine the logic and popularity of the programs.

EITC liberalization. In my view the most efficient method of improving the well-being of poorer workers is to raise the net benefits they can receive under the Earned Income Tax Credit. Benefits under the program are targeted specifically on workers, and they tend to rise for the poorest workers as their wage earnings rise. Thus, the money goes to a group that has been battered by recent economic developments, and it is offered in such a way that it encourages some wage earners to work harder or find a better job.

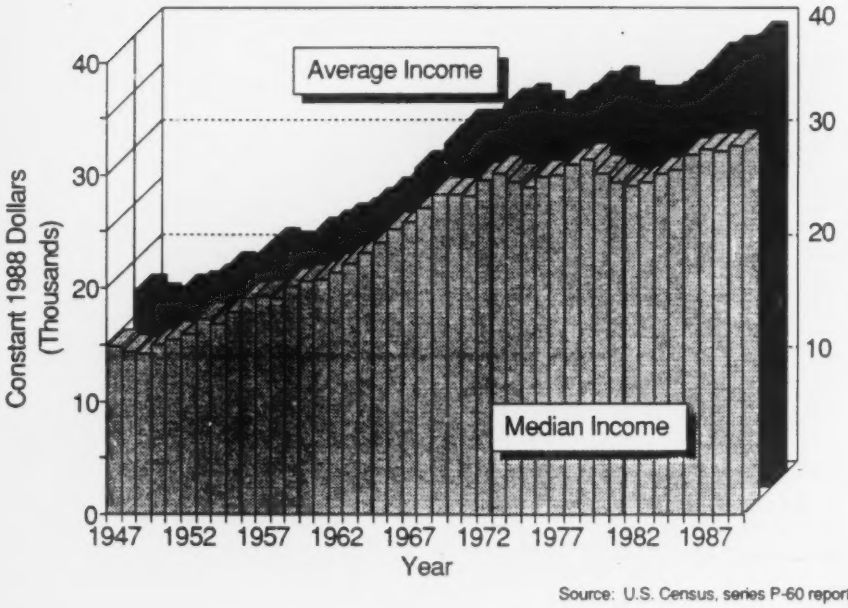
Congress has twice liberalized the credit since 1985, but even with this liberalization the House Ways and Means Committee estimates that the program costs less than one-half of one percent of federal government revenues. To improve the program still further, the Congress could raise the rate of earnings subsidy for workers with large families, reduce the rate of taxation as the credit is phased out at higher income levels, or broaden eligibility criteria so that workers older than age 20 can receive a credit, even if they do not have dependent children.

Long-run remedies. In the long run, it is unlikely that anemic wage growth and growing income disparity will be remedied solely through changes in the nation's tax and transfer system. One of the most troubling aspects of recent income trends has been the steady deterioration in the labor market position of less skilled workers, especially men. If there has been a drop in

demand for unskilled labor, the obvious policy response is to improve the qualifications of less skilled worker to match the apparent requirements of the job market. If the nation has too many unskilled workers, rather than too many bad jobs, both efficiency and equity would be served by improving the skills of workers now lodged at the bottom.

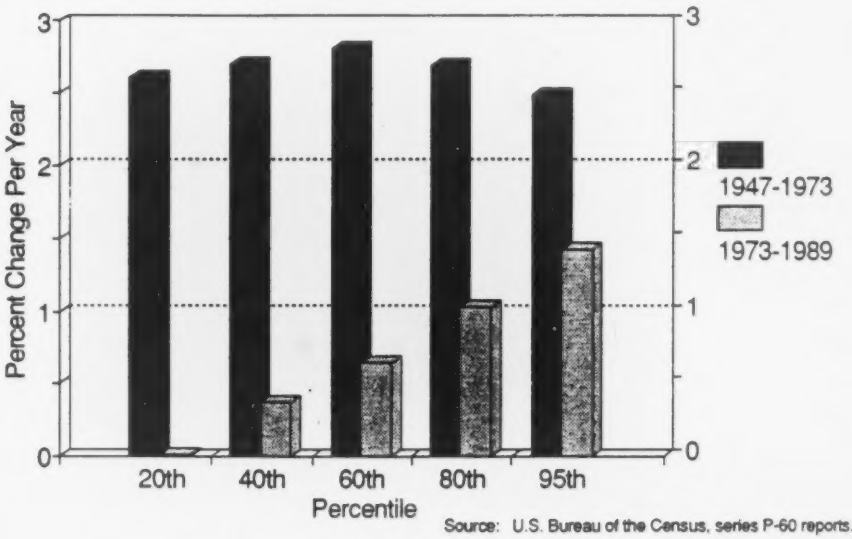
In my view the most plausible policies to address this problem must involve the nation's troubled school system, especially as it affects non-college-bound youth, and the private sector's efforts to train or retrain less skilled adult workers. The school system must be reformed so that it concentrates much more on job preparation of children who are not destined to go to college. These kids should leave schools with at least the level of basic education that will make them ready to be trained by modern employers. And they should take with them a recognized certificate showing that necessary skills have been attained. Both for new labor market entrants and mature adults, the tax system could be revised to provide much greater incentives encouraging employers to invest in the training of their workers. In the long run, only investments of this type will remedy the severe labor market problems that afflict the less skilled.

Fig. 1. Median and Average Family Income, Constant 1988 Dollars, 1947-89



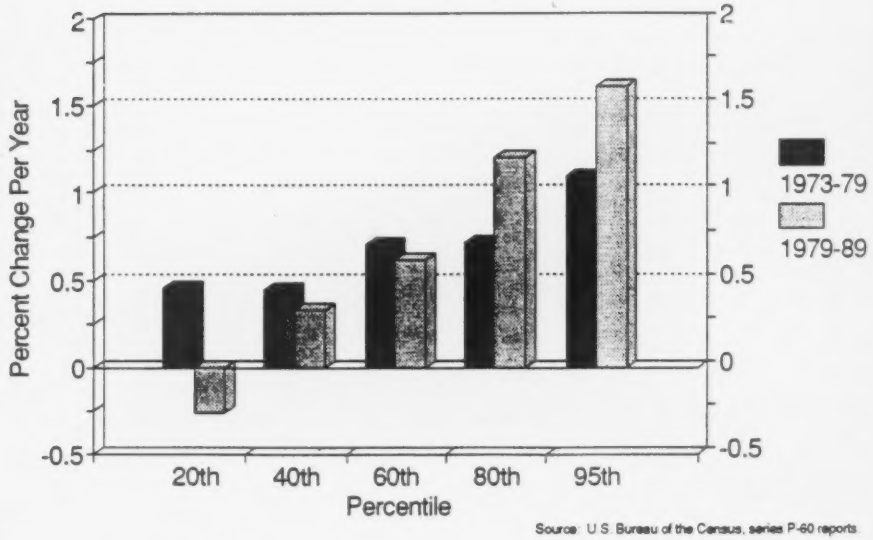
Source: U.S. Census, series P-60 reports.

Fig. 2. Annual Growth in Family Income, Selected Parts of Distribution, 1947-89



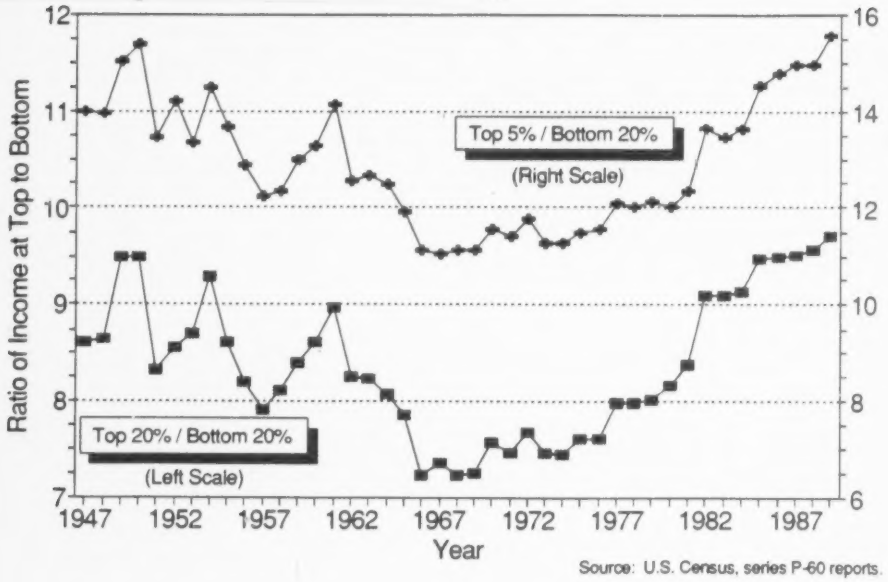
Source: U.S. Bureau of the Census, series P-60 reports.

Fig. 3. Annual Rate of Change in Family Incomes, Selected Percentiles, 1973-89



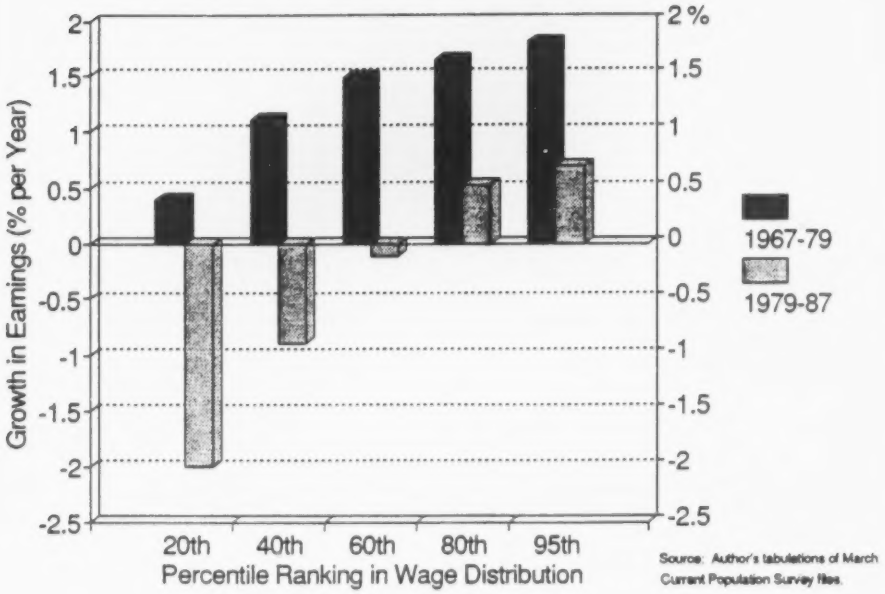
Source: U.S. Bureau of the Census, series P-60 reports

Fig. 4. Family Income Distribution
(Ratio of High to Low Incomes), 1947-89



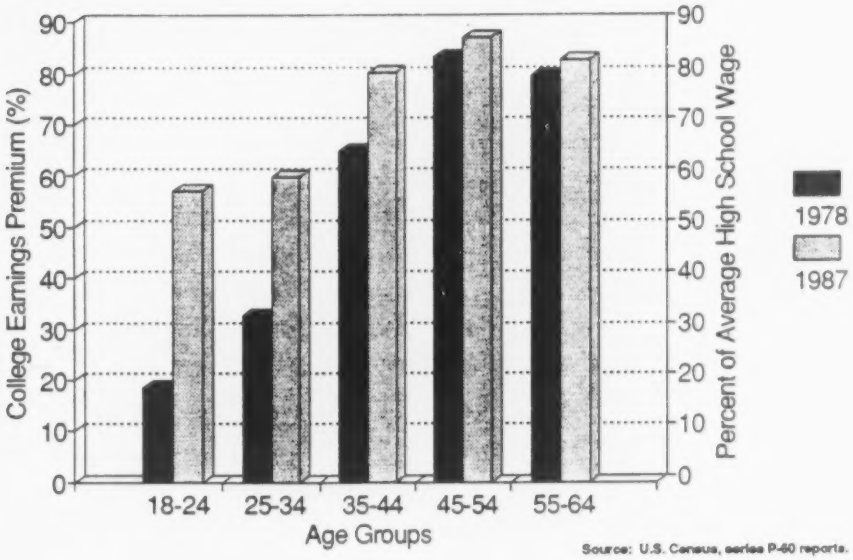
Source: U.S. Census, series P-60 reports.

Fig. 5. Rate of Growth in Male Wages, Selected Parts of Distribution, 1967-87



Source: Author's tabulations of March Current Population Survey files.

Fig. 6. Earnings Premium for College Completion among Males, 1978 and 1987



Source: U.S. Census, series P-60 reports.

Table 1. Share of Aggregate Income Received by Each Fifth of U.S. Families, Selected Years, 1949-89

Percent

Year	Quintile					Top 5 Percent
	Bottom	Second	Middle	Fourth	Top	
1949	4.5	11.9	17.3	23.5	42.7	16.9
1954	4.5	12.1	17.7	23.9	41.8	16.3
1959	4.9	12.3	17.9	23.8	41.1	15.9
1964	5.1	12.0	17.7	24.0	41.2	15.9
1969	5.6	12.4	17.7	23.7	40.6	15.6
1974	5.5	12.0	17.5	24.0	41.0	15.5
1979	5.2	11.6	17.5	24.1	41.7	15.8
1984	4.7	11.0	17.0	24.4	42.9	16.0
1989	4.6	10.6	16.5	23.7	44.6	17.9

Sources: U.S. Bureau of the Census, *Money Income of Households, Families, and Persons in the United States*, series P-60, nos. 162 and 168.

Chairman SASSER. We'll turn now to Mr. McIntyre—and I would say to Mr. McIntyre and Mr. Kosters both, please feel free to summarize your testimony this morning.

STATEMENT OF ROBERT McINTYRE, EXECUTIVE DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman, and thank you to the other Senators for your well-designed and informative charts. I certainly enjoyed them, and I hope you like my statistics when you have heard them, Senator Domenici in particular.

I think today's hearing is a very important one in continuing the concern that was begun last year about the shifts in income and taxes over the past decade and a half. It is clearly true that since the mid-1970's, the rich have gotten much richer, while their taxes have plummeted, but for most people, incomes have stagnated and taxes have risen.

I'd like to respond in particular to the questions the chairman put to me in his letter. And by the way—and Senator Domenici, I think this is an important thing—I thought in your statement it was interesting to note that the period of the supply-side tax changes, so-called, the 1978 and 1981 tax bills, as you pointed out in your charts was not a good one for the economy or for ordinary people, and that things have gotten somewhat better since the tax change that were made in 1982 and 1984 and 1986, which were all tax increase bills designed primarily to take back some of the tax cuts for the very wealthy that had been given in those earlier bills. So I am 100 percent behind you that those later changes went in the right direction and the earlier ones went the wrong way.

Senator DOMENICI. But I didn't say that.

Mr. MCINTYRE. You didn't say that, but your charts seemed to indicate it.

Senator DOMENICI. You say that; I didn't say that.

Mr. MCINTYRE. If you look at our Federal tax code today, you find that although there are some progressive taxes—the personal income tax is somewhat progressive, the corporate income tax, what is left of it, is progressive—there are many other regressive offsets—excise taxes and particularly the payroll tax. This leaves us with a system where except for the poor, almost every income group in this country from the middle up to the very rich is paying at almost the same effective tax rate. The range is only between about 20 and 27 percent these days for middle income all the way up to billionaires.

The social security tax is important here, especially the part of it that no longer goes to pay for social security but goes to pay for the Defense Department and other government programs that have nothing to do with social security. Social security is a very good system overall and a progressive system, but not when the payroll tax money is diverted to other uses.

Now, if you compare this to earlier years, say before 1978, the very modest level of overall progressivity in our current system is quite a bit different from how things used to be. If we had a system that was as progressive as it was in 1977, 9 out of 10 families would pay lower taxes than they do now. The poor would pay about one-

fifth less; the middle class would pay about one-tenth less. But the very wealthy would pay almost half again what they now pay in Federal taxes.

The role of the tax code in mitigating income disparities has been greatly reduced. The table [1] on page 2 of my testimony summarizes that. Basically if you go back 13 years, you see that the gap in after-tax income between the very welloff and the middle class or the poor was substantially reduced—by almost one-third between the rich and the middle class. These days, only about one-fifth or one-tenth of that disparity is offset.

When you put that together, you see that while pre-tax income lagged for middle-income and low-income families over the last decade and a half, their after-tax income did even worse. And the converse is true for the very wealthiest; their pretax income went up by about 76 percent; their aftertax income went up by 110 percent.

Now, it is important to note that last year's budget bill did have a positive impact on the progressivity of the system, but it was a relatively minor one. It did take back about one-tenth of the Reagan era tax cuts for the very wealthy, and it did make the system a little bit more progressive. But it didn't do very much.

Now, when we talk about the pretax income shift, I think it is important to also note that when you change the tax system so radically as it was done in 1981 in particular, and you cut taxes so dramatically for high-income people, that's going to affect their future income. Unless they spend every penny of their tax cut, they are going to have more interest and dividends and capital gains in the future. And if you take that into account, the shift, raising taxes on the middle class, cutting them on the very wealthy, and put just a portion of that tax shift into increased or decreased savings by those groups, you can, without much effort and even assuming very low interest rates assumed calculate that about two-thirds of the shift in aftertax income in favor of the very wealthy at the expense of the rest of us was due to the supply-side tax cuts of 1978 and 1981.

There were many different factors at work here, and I'm sure you could find enough explanations for the income shift effects to add up to more than 100 percent; some are offsetting. But the tax cuts clearly played a very major role in the shift in both pretax and aftertax distributions of income.

Now, of course, the public Treasury had a lot at stake in this, too. When you had a situation where almost all the serious income growth was going to the very wealthiest people, and at the same time their taxes were being cut so substantially, obviously that is going to have a major impact on the deficit. You can calculate that the 1990 costs of the tax cuts for the very wealthiest people, just the top 1 percent, totalled $160 billion last year. That includes $84 billion in direct tax cuts and another $73 billion in interest on the close to $1 trillion in debt that was built up to pay for the earlier years' tax cuts for this select group.

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[1] See p. 53.

So this linkage that we have here between the tax code fomenting income inequality and at the same time this inequality in taxes and incomes fomenting the budget deficit seems to me to be pretty clear. A primary cause of many of our problems today, including the trade deficit and the budget deficit, is the tax changes of the very early 1980's. And that's despite the efforts, and they were substantial efforts, to undo some of those changes in subsequent years.

So what could we do about it? Well, I think, simply put, we should take back the tax cuts that were given to the very wealthy people. The justification for these tax cuts was that they would increase savings, lead to more investment, make all of us better off, eventually come out the other end of the horse, and we'd all be fine.

It didn't quite work out that way. Most people's incomes didn't go up; they actually fell or stagnated. Business investment did very poorly in the early half of the 1980's, and only picked up after tax reform in 1986. Tax reform was a good thing. It tried to close down some of the loopholes, and we would suggest you should close down more of them as the basic approach to taking back some of the tax cut for the wealthy.

If you look at business investment in the first half of the 1980's in real terms, its growth was about 2 percent a year. Since the Tax Reform Act, it has been over 5 percent a year. Industrial equipment investment declined in the first half of the 1980's; it has been growing at about 6 percent a year since. That makes sense. If you get people to stop investing in all these tax shelters that were created by the 1981 Tax Act, they have to put their money somewhere, and it won't be under the mattress—it will be back into useful activities.

Another question the chairman asked was whether we ought to be thinking about tax cuts for middle- and low-income people. Well, perhaps. If you were to take back a substantial portion of the huge tax cut that has gone to the wealthiest among us, some of the revenues might be devoted to middle- and low-income tax cuts. But I think the primary focus ought to be devoted to giving people something for their tax dollars. What we have been seeing in the 1980's is that people are paying more for government, yes, but they are also getting quite a bit less. Nondefense, noninterest, nonsocial security programs fell by one-quarter as a share of the GNP in the 1980's.

So when people are mad at government, it is not just that their taxes are too high; it is that they are not getting what they ought to get for their tax money. We're seeing the effects of spending cutbacks in the declining infrastructure, the child welfare problem detailed in today's Washington Post and our education problems. We need to put some more money into those areas. That would be good for the long run future of everybody in this country.

You know, a lot of people talk about the 1980's as the decade of overconsumption. It certainly was, but not on the part of most people. Their incomes did not go up; they did not overconsume. The wealthy did, and we paid for it. It is time to take the tax cuts back.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Mr. McIntyre.

[The prepared statement of Mr. McIntyre follows:]

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Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Concerning Trends in Income and Taxes
Before the Senate Budget Committee
February 22, 1991

I appreciate the opportunity to appear before the committee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The Committee's concerns about the concurrent shifts in income and taxes over the past decade are well founded. Indeed, since 1977, the rich have gotten much richer as their taxes have shrunken, while incomes for middle- and low-income families have stagnated or fallen as their taxes have risen.

My written statement today includes responses to the specific questions presented to me by Chairman Sasser, along with a copy of a paper published by Citizens for Tax Justice last year on these same issues. I will discuss both in my oral presentation.

1. How progressive is the federal tax code today? How does it compare to how progressive the tax law was previously? Did the 1990 tax changes make the code more progressive?

The federal tax system is a combination of taxes, some that are at least modestly progressive, others that are regressive. Personal and corporate income taxes are the chief progressive taxes, although the former is considerably less progressive than it used to be, while the latter plays a far smaller role than in the past. (In the 1960s, corporate income taxes paid for almost a quarter of non-social-security federal spending; this year, corporate income taxes are expected to cover less than 12 percent.)

According to the Congressional Budget Office, in 1990 effective personal income tax rates ranged from less than zero on the poor, to about 7 percent on middle-income families, up to 21.5 percent on the very rich. Corporate income taxes, which have little effect on the poor, took about 1.8 percent of the income of middle-income families and 3.7 percent of the income of the very rich.

On the regressive side of the ledger are excise taxes on items such as gasoline, cigarettes and alcohol, and Social Security payroll taxes, which apply only to wages and self-employment income up to $53,900 per person (except for the HI tax, which applies to up to $125,000 in earned income starting in 1991). The CBO says that in 1990 federal excise taxes cost poor families 2.4 percent of their incomes, that middle-income families paid 1 percent of their incomes in excise

taxes, and that the very rich paid a mere 0.3 percent of their income in excise taxes. Social Security payroll taxes (employee and employer combined) took 6.1 percent of the income of poor families, 10.7 percent of the income of middle-income families, and a mere 1.6 percent of the income of the very rich. (Taking account of Social Security benefits, however, makes the payroll tax look considerably better.)

The decline in progressivity over the past decade and a half:

Today's very modest level of progressivity is a far cry from what was in place in 1977. If that level of progressivity had been retained, in 1990 the poor would have paid almost 20 percent less in federal taxes than they actually had to pay. Middle-income families would have paid almost 10 percent less. But the very rich would have owed more than half again what they actually paid.

In 1977, the average pretax income of the richest one percent of all families was $295,000 (in 1990 dollars)—33 times more than the poorest fifth of all families and 9 times as much as the typical middle-income family. Progressive federal taxes reduced the gap significantly, however. The after-tax income of the richest one percent was "only" 24 times that of the poor and "only" 7.3 times that of middle-income families. In other words, the federal tax system reduced the disparity between rich and poor by almost a third, and cut the disparity between rich and middle-income families by one fifth.

By 1990, the pretax income of the richest one percent had jumped to $549,000—71 times that of the poor and 17.3 times that of middle-income families. But the tax code no longer mitigates these differences very much. After taxes, the 1990 income of the richest one percent was 57 times that of the poor and 15.9 times that of middle-income families. In fact, the *after-tax* income advantage of the rich over poor and middle-income families in 1990 was close to twice as large as the *pretax* disparity in 1977.

The Declining Role of the Federal Tax System in Reducing Income Disparities, 1977 to 1991

	1977		1990		1991 Law
	Pretax	After-tax	Pretax	After-tax	After-tax
Ratios of Average Incomes:					
Rich/Middle	9.0	7.3	17.3	15.9	15.6
Rich/Poor	33.0	23.6	71.1	57.3	55.8
Reduction in Pretax Income Disparities from Federal Tax Progressivity:					
Rich/Middle	-20%		-8%		-10%
Rich/Poor	-29%		-19%		-21%

"Rich" refers to families at the top 1 percent of the income scale. "Middle" refers to families in the middle 60 percent of the income scale. "Poor" refers to the poorest 20 percent of all families. Figures are based on data from the Congressional Budget Office.

The 1990 budget act's effects on progressivity:

Although last year's tax changes were modestly progressive, they do not affect the story very much. Although the 1990 Budget Act took back about a tenth of the tax cut en-

joyed by the richest families, the tax code continues to offset only about a tenth of the income disparity between the very rich and middle-income families, and only about a fifth of the disparity between the rich and the poor.

The role of the tax shift in augmenting the income shift:

It should be noted that the shift in pretax income in favor of the wealthy and the simultaneous shift in taxes away from them were not independent events. Obviously, cutting taxes for the well-off and raising them on middle- and low-income families has wealth effects, and these in turn affect future earnings from interest, dividends and capital gains. From 1977 to 1990, the share of total after-tax income going to the top one percent of all families increased from 7.3 percent to 12.5 percent (a 71 percent jump), while the share of after-tax income going to the bottom 90 percent declined. Making reasonable assumptions about savings and interest rates, we have calculated that some two-thirds of that shift in after-tax income toward the top one percent can be attributed to the supply-side tax changes of 1977 and, especially, 1981 (even despite offsetting reforms in subsequent years).

The cost to the Treasury of the tax shift:

We also calculate that the total cost to the federal Treasury of tax cuts granted to the top one percent since 1977 amounted to almost $160 billion in 1990 alone, including both $84 in direct tax reductions and another $73 billion in interest expenses on the $860 billion in added federal debt built up to pay for tax cuts for this elite group in previous years.

The 1990 Cost of the Supply-Side Tax Cuts for the Richest 1 Percent

	Tax Cut ($-bill.)	Interest Rate (3-yr. T-bonds)	Compounded Addition to Debt ($-bill.)
1978	$3	8.3%	$3
1979	7	9.7%	11
1980	8	11.6%	21
1981	14	14.4%	39
1982	41	12.9%	87
1983	45	10.5%	144
1984	49	11.9%	213
1985	53	9.6%	289
1986	59	7.1%	371
1987	65	7.7%	467
1988	71	8.3%	580
1989	78	8.6%	711
1990	$84	8.5%	$860

1990 Summary

Tax Cut for Top 1%: $84 billion

Interest on Added Debt: $73 billion

TOTAL 1990 COST*: $158 billion

**Not including effects on interest rates.*

2. What could be done to make the tax code more progressive? What would be the revenue impact of increasing the progressivity of the tax code?

Last year, Citizens for Tax Justice proposed a number of specific tax changes designed both to restore progressivity to the tax code and reduce the budget deficit. Among the particular changes we suggested were:

- Increasing the top income tax rate on corporations and high-income individuals to 38 percent.
- Strengthening both the personal and corporate alternative minimum taxes (which are intended to assure that no wealthy individual or profitable company is able to avoid significant taxes through the remaining loopholes in the regular income tax).

- Restructuring the taxation of multinational corporations, both foreign and domestic, to assure that U.S. corporate taxes are paid on profits earned within the United States. (A longer list and description of our proposals can be found in the attached paper.)

As noted above, the 1990 budget act did move modestly in the direction of restoring progressivity. But most of the proposals that we made last year remain current. The bottom line is this: If the tax code were as progressive as it was when President Ford left office in 1977, the richest one percent of Americans would pay approximately $75 billion more in federal taxes than currently (even after the 1990 tax changes).

3. In view of the stagnating incomes of middle and lower-middle income Americans, what are the tax policies that might be pursued to appropriately reduce tax burdens on these income groups?

Were Congress and the President to take back the tax cuts granted to the very best-off Americans, some of the enormous revenues that would be raised obviously could be devoted to offsetting the tax increases that have fallen on average families. That might be accomplished through increases in the standard deduction or the personal exemption, or perhaps through some offset for a portion of Social Security taxes.

The valid complaint that middle-income families have about the trends in government finance over the past decade, however, is not merely that they are paying more for government, but also that they are getting less. From 1980 to 1989, the cost of all non-defense federal programs, excluding Social Security and interest, plummeted from 9.7 percent to 7.3 percent of the gross national product, a drop of 25 percent.

While that trend is beginning to be reversed (at least in some areas), our nation still confronts the damage from a decade of neglect of domestic needs, ranging from education to infrastructure to child welfare. Thus, even if the budget deficit is solved, a major social deficit remains that the revenues raised from reversing the tax shift could and should help address.

Conclusion

The decade of the 1980s is often described as one of gross over-consumption on the part of America at the expense of our future and that of our children. Our budget and trade deficits make clear that, as a nation, that charge is indeed true. But tax cuts for average families were not the source of that profligacy. On the contrary, most families saw their taxes rise over the past decade and a half, even as their incomes stagnated or fell.

The truth is that America's over-consumption as a nation stems from huge tax breaks granted to the very wealthiest Americans at the end of the 1970s and the start of the 1980s. In subsequent years, these people saw their incomes and wealth grow by leaps and bounds, even as the nation that defends them, protects them and makes their way of life possible grew poorer and more indebted by the minute.

In last year's deficit-reduction bill, Congress faced up to the need to turn away from the policies of the 1980s, and took a step in the direction of tax fairness and fiscal responsibility. We hope that today's hearing will keep attention focused on the need to continue on that course, so that we can stop sacrificing our future economic well-being in order to underwrite the conspicuous consumption of the very rich.

Inequality & The Federal Budget Deficit

Robert S. McIntyre
Citizens for Tax Justice

OVER THE PAST DECADE, something very troubling has been going on in this country. The quintessentially American hope and expectation that each generation will be better off economically than its parents has not only been put on hold for most members of the current generation, it has been systematically undermined for the next generation as well.

Increasingly, more and more of our nation's wealth is being dissipated, as we borrow against tomorrow to pay for current spending. Less and less of that spending is going into the investment we need—both private and public—to improve our standard of living and our children's in the future.

The primary culprit in creating this problem is the federal government and its newly-adopted policy of borrow and spend. In the decade of the 1980s, federal borrowing averaged 4.1 percent of the gross national product, by far the highest sustained level outside of wartime in our nation's history. As a result, we have saddled ourselves and our children with an additional $1½ trillion in debt, a large share of which is owed to foreign investors.

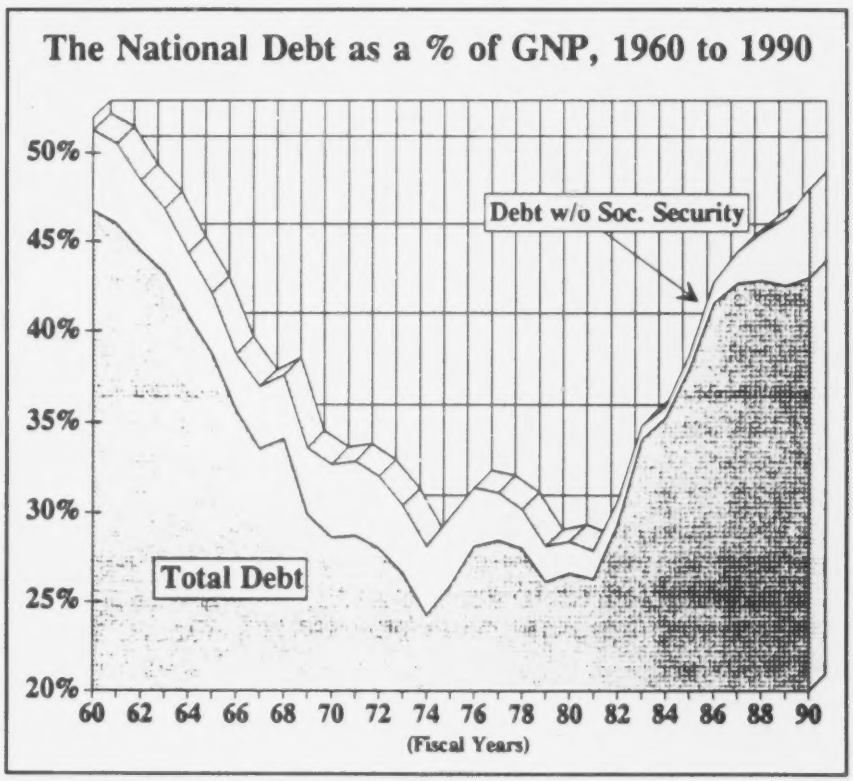
The radical build-up of government debt in the 1980s is a sharp break from the past. Although budgets have rarely been completely balanced, every post-World-War-II administration until President Reagan's succeeded in reducing the national debt as a share of the gross national product.

Coinciding with the growth in the deficit has been a sharp redistribution of income in favor of the wealthy. Indeed, this growth in inequality—and the strident, often self-righteous unwillingness of those who

enjoy new-found riches to pay taxes on their enormous gains—underlies most of the government's deficit problem.

Our nation's job is not an easy one. Powerful interests that have benefitted from the borrow and spend policies of the 1980s have become even more powerful as a result. They will continue to resist the idea that the government must pay for what it spends, because they know full well that they are the ones who are the cause of the government's failure to do so. As a last resort, they will try to send the bill to the middle- and low-income families of America.

But the assertion that more inequality is what this country needs is dead wrong. Addressing inequality is the only fair way, and probably the only politically conceivable way, to reduce the deficit and begin to recover from the irresponsible binge of the past decade. We as a nation need to act, before we have mortgaged our future so badly that we cannot recover.



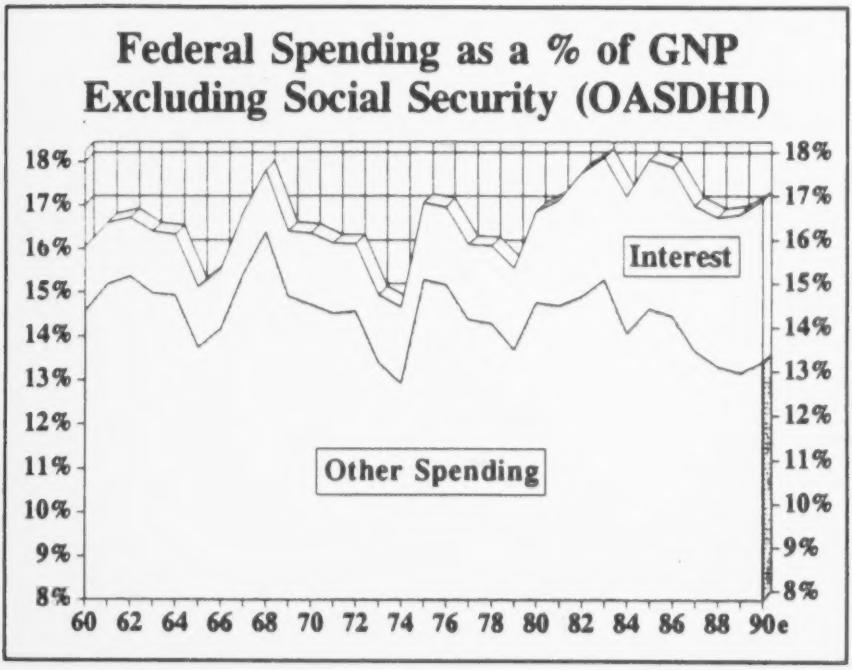
What Caused the Federal Budget Deficit?

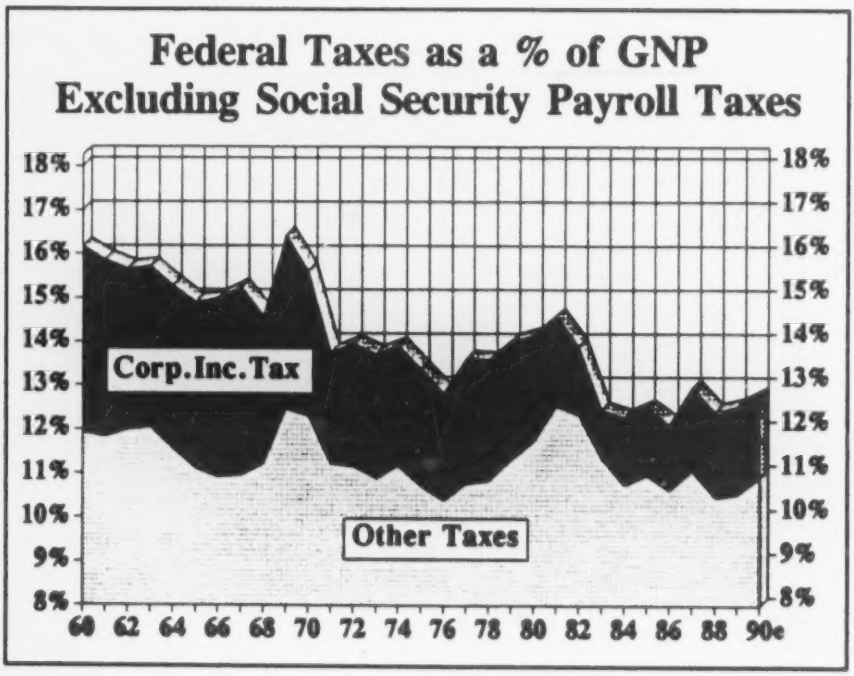
IT'S A TRUISM that, as a nation, we are failing to come close to paying for the full cost of our government. But is the source of this reckless behavior too much spending or too little taxes? Those who assert that excessive spending is the problem point out that since 1969 (the last year the budget was in balance) total federal spending rose from 19.7 percent of the gross national product to 21.9 percent in fiscal 1989—an increase of 2.2 percent of the GNP. Over the same period, total federal taxes fell by "only" 1.1 percent of the GNP—from 20 percent to 18.9 percent. Therefore, they argue, increased spending is the primary villain.

In the past, spending critics have often pointed to growth in "entitlements"—a code word for Social Security—as the main source of our deficit problem. But thanks to the recent efforts of Senator Daniel Patrick Moynihan, it is clearer than ever that assertions about supposedly unrestrained federal spending are far off the mark. Indeed, to blame Social Security for the deficit problem is ludicrous. Certainly, Social Security benefits have risen over the years, but so have Social Security *taxes*. In fact, Social Security (OASDHI[1]) now is running a huge budget surplus—amounting to some 1.4 percent of the GNP in fiscal 1990, and expected to be almost 2.1 percent of the GNP in 1993.[2] Indeed, as Senator Moynihan has stated so lucidly, successive administrations, with congressional acquiescence, have been stealing from the Social Security trust fund to an ever-increasing degree, and using the regressive payroll tax to mask the full size of our deficit problem.[3]

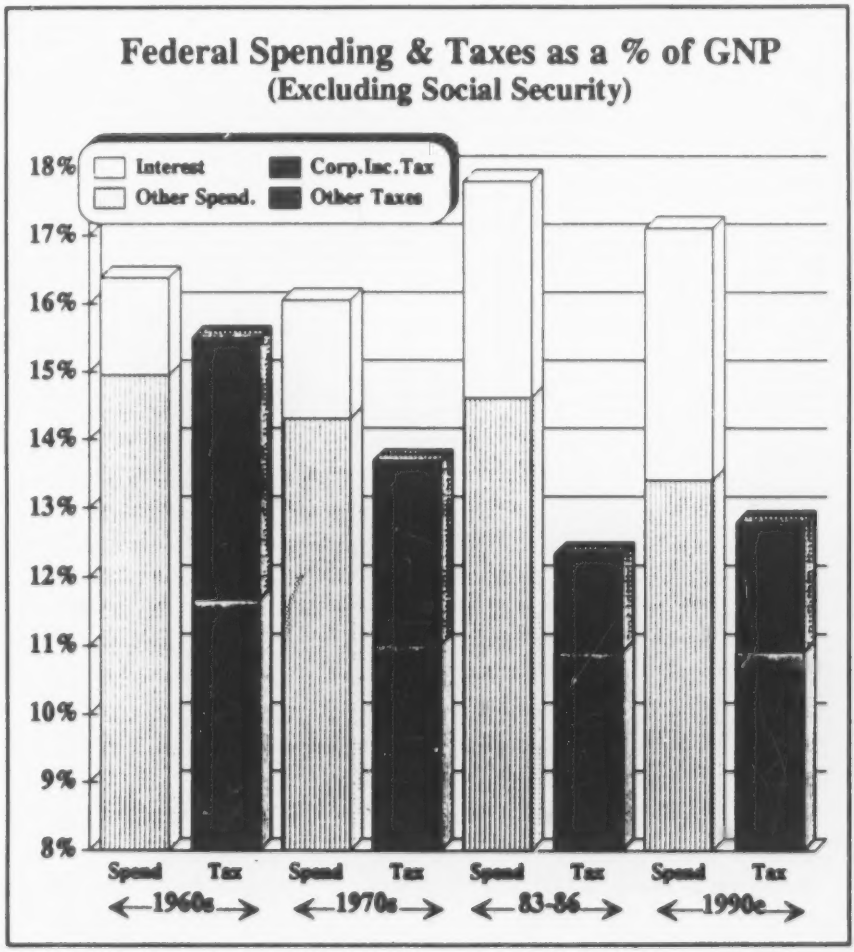
Putting aside Social Security shows a quite different picture:

- **Spending:** The cost of non-Social-Security federal programs as a share of the GNP is now *lower* than it was in the sixties, seventies or early eighties![4] Interest on the national debt, however, is up sharply.[5]
- **Taxes:** In contrast, non-Social-Security federal taxes have declined markedly as a share of the GNP—from 15.5 percent of the GNP in the sixties, to 13.7 percent in the seventies and to only 12.8 percent in the current fiscal year.


Federal Spending as a % of GNP
Excluding Social Security (OASDHI)
18%
17%
16%
15%
14%
13%
12%
11%
10%
9%
8%
Interest
Other Spending
60 62 64 66 68 70 72 74 76 78 80 82 84 86 88 90e


Federal Taxes as a % of GNP
Excluding Social Security Payroll Taxes
18%
17%
16%
15%
14%
13%
12%
11%
10%
9%
8%
Corp.Inc.Tax
Other Taxes
60 62 64 66 68 70 72 74 76 78 80 82 84 86 88 90e

■ **The Deficit:** Looking at non-Social-Security spending and taxes together makes the source of the deficit clear. Although the cost of non-Social-Security programs (excluding interest) is down as a share of the GNP, non-Social-Security *taxes* are down even more. Of course, interest on the national debt looms extremely large in the deficit picture. But added federal interest outlays reflect increased debt due to previous deficits—deficits incurred primarily because of insufficient tax revenues in earlier years.



The Alarming Growth in Inequality

TO UNDERSTAND that insufficient revenues are at the heart of our deficit dilemma is an important first step in moving toward a solution to that problem. But it is equally critical to recognize *whose* taxes we are talking about. Again, the data are very clear.

The tremendous shift in taxes: Study after study has concluded that despite all the rhetoric about allegedly "across-the-board" tax cuts, taxes have *not* been reduced for most Americans over the past decade. The most comprehensive report on this topic was issued in February 1990 by the House Ways and Means Committee, and covered the entire range of federal taxes, including personal and corporate income taxes, social security taxes and excise taxes. The data show that nine out of ten American families actually are paying a *higher* share of their incomes in overall federal taxes than they did prior to the so-called "supply-side tax cuts" enacted in 1978 and 1981! Only the richest 10 percent of the population has enjoyed a reduction in taxes since 1977, with most of the tax cuts concentrated on the richest one percent.[6] Indeed, we calculate that compared to the 1977 tax system adjusted for inflation, the effective federal tax rate on the wealthiest one percent of the people has dropped by 15 percentage points. That means an *average* 1990 tax cut for the super rich of $82,196 each—a 36 percent tax reduction compared to the 1977 rates.[7]

The enormous shift in incomes: These regressive tax changes have coincided with and augmented an alarming shift in the distribution of pretax income in America—toward less equality. The Ways and Means data reveal that, adjusted for inflation, real pretax earnings have stagnated or fallen for most segments of the population over the past 10 years, while the best-off people—most notably the richest 1 percent—have enjoyed huge increases in real income.

In 1977, the wealthiest one percent of the population took in 8.7 percent of total pretax income. Today, 13.2 percent of total income is concentrated on this elite group. The *average* pretax income of the richest one percent has zoomed from $294,900 each in 1977 (in 1990 dollars) to $549,000 each this year—an 86 percent jump. Over the same period, the share of total income going to the bottom four-fifths of all families fell from 53.6 percent to only 48.5 percent.

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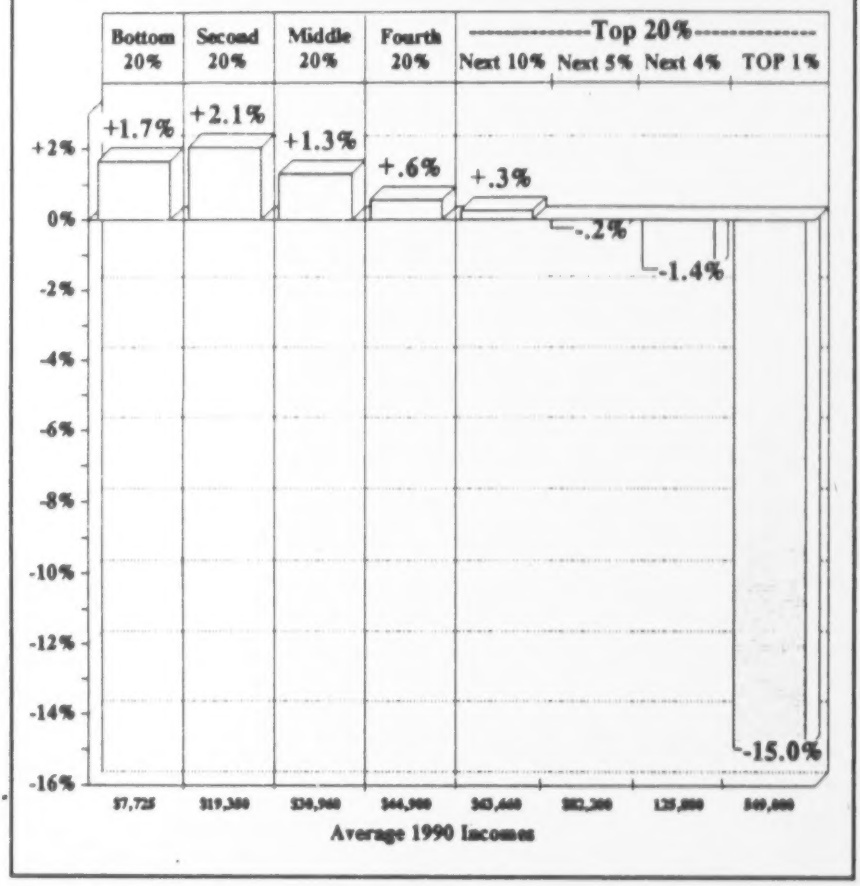
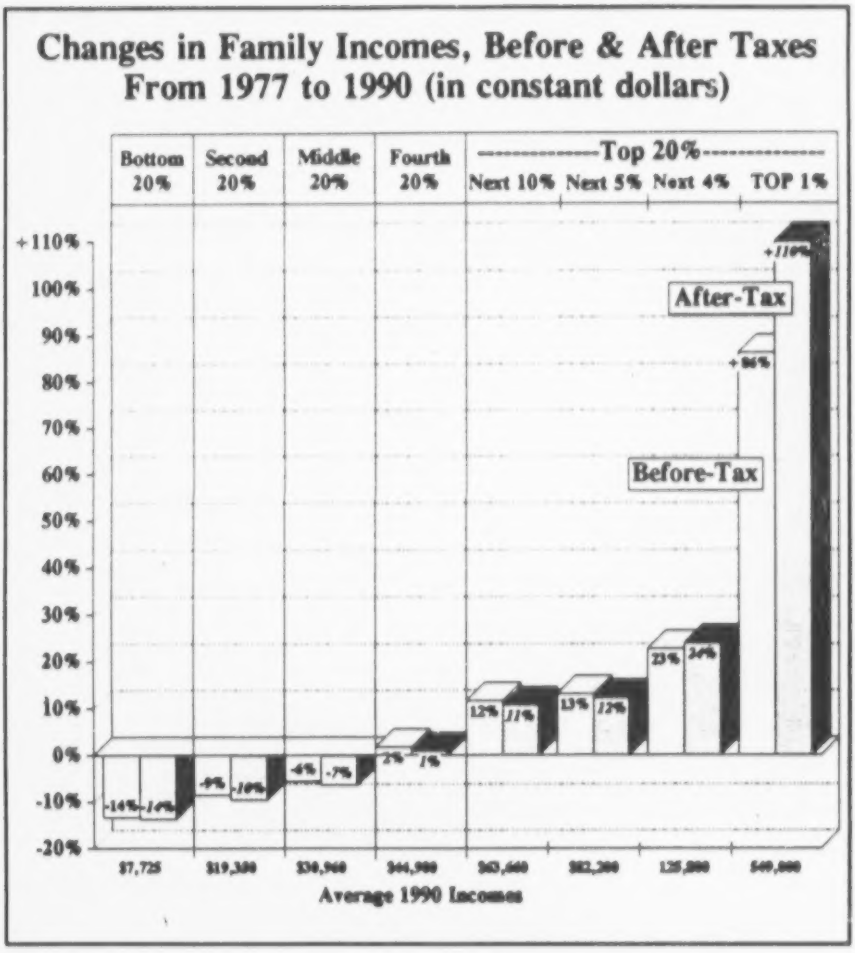
Changes in Total Federal Taxes, 1977 to 1990 As Shares of Family Incomes

1990 Compared to 1977 Tax Rates Adjusted for Inflation[7]



The dramatic after-tax shift in incomes: The government's policy of cutting taxes on the rich even as their incomes skyrocketed has made the shift in after-tax incomes particularly dramatic. For middle- and lower-income families in the first three income quintiles, real after-tax income has actually declined since 1977.[8] The real after-tax earnings of families in the fourth quintile grew by less than one percent over ten years. But the real after-tax income of the richest one percent of the population jumped by a staggering 110 percent!



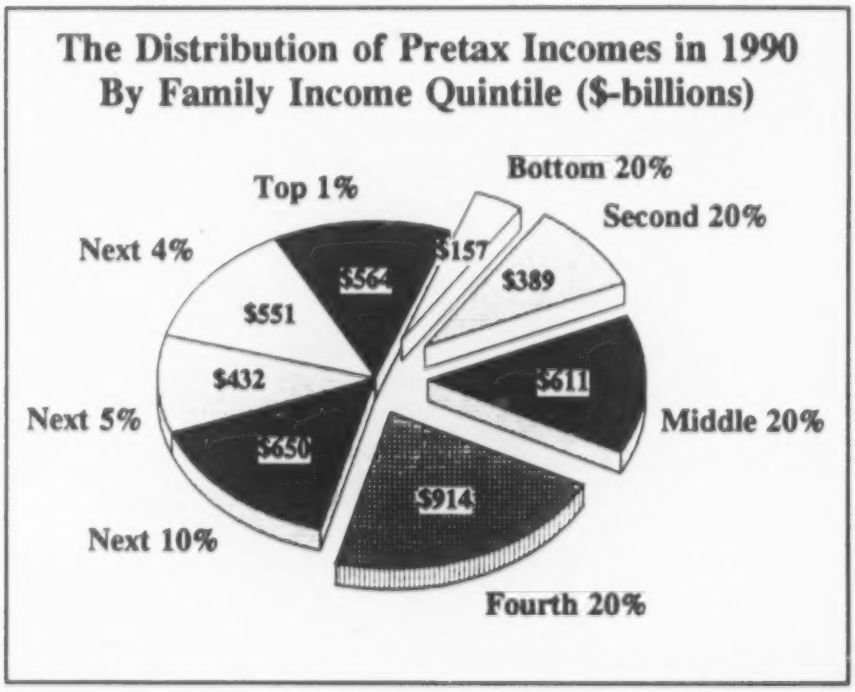
The very rich—making more and paying less: The share of pretax income garnered by the top one percent of the population has increased enormously. But this group's share of the total federal tax burden has not come close to keeping pace. From 1977 to 1985, the share of federal taxes paid by the richest one percent actually *fell*. And despite the mitigating effects of the 1986 tax reform act, today the top one percent's share of total federal taxes is up by only 15 percent compared to 1977, despite the 51 percent jump in their share of total pretax income.

The decline in taxes on the wealthy reflects not only reductions in personal income taxes, but also the sharp drop in the corporate income tax, which fell from 3.8 percent of the GNP in the sixties, to 2.7 percent

in the 1970s and to only 1.4 percent in the mid-1980s. Even after the 1986 tax reform act brought many former corporate freeloaders back on the tax rolls, corporate income taxes—at 1.9 percent of the GNP—remain well below their level in the sixties and seventies.[9]

The rich really are rich: How can tax cuts for such a small proportion of our population cause such a large drop in tax revenues, and loom so large in the deficit picture? It's simple arithmetic. The rich do, in fact, get a huge share of our nation's income.

- This year, the richest one percent of the population will make $564 billion before taxes. That's more than the total income of the bottom 40 percent of all families.
- The $2.2 *trillion* in income concentrated on the top fifth of the nation's population—people making more than about $56,000 a year—is greater than the total earnings of the remaining four-fifths of American families.

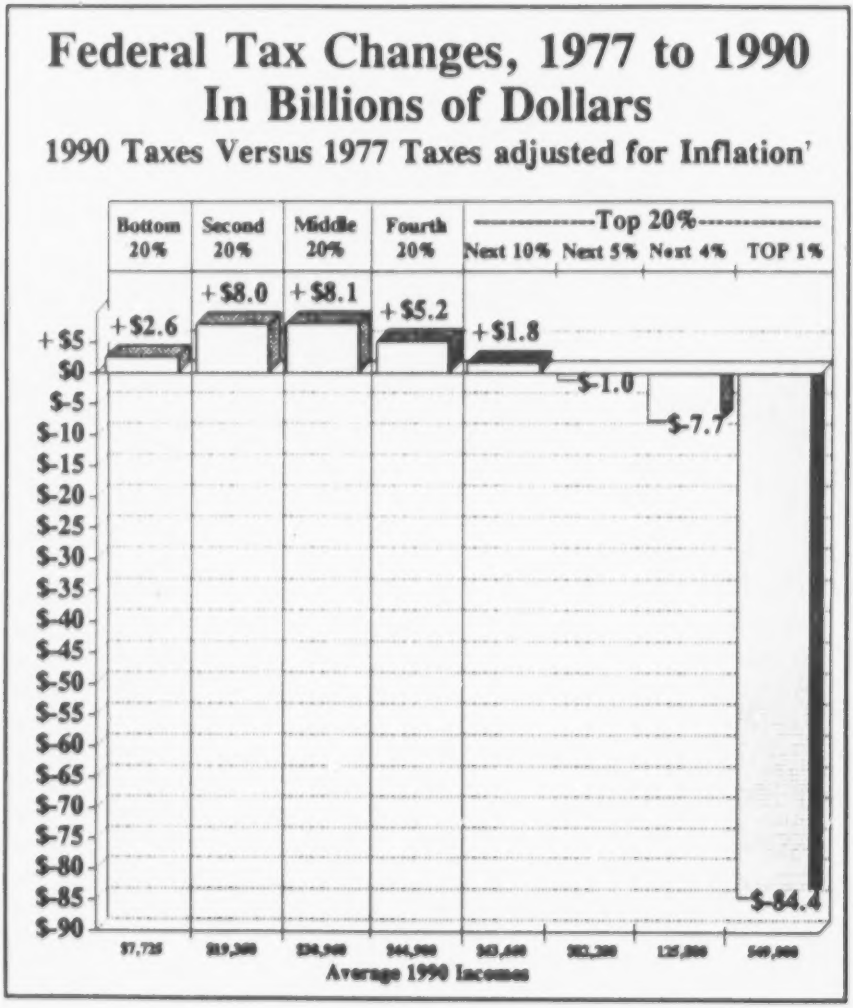


Adding up the tax cut for the rich and the tax hikes on everyone else: What does a 36 percent tax cut that amounts to 15 percent of income for the wealthiest one percent of the people add up to? More than

$84 billion per year. If instead of showering tax cuts on the rich, Congress had simply kept the tax system as progressive as it was prior to the "supply-side" tax changes of 1978 and 1981 (by adjusting the 1977 system for inflation), then:

- Nine out of ten families would pay lower federal taxes than they do now, and
- The Treasury would collect almost $70 billion more annually.

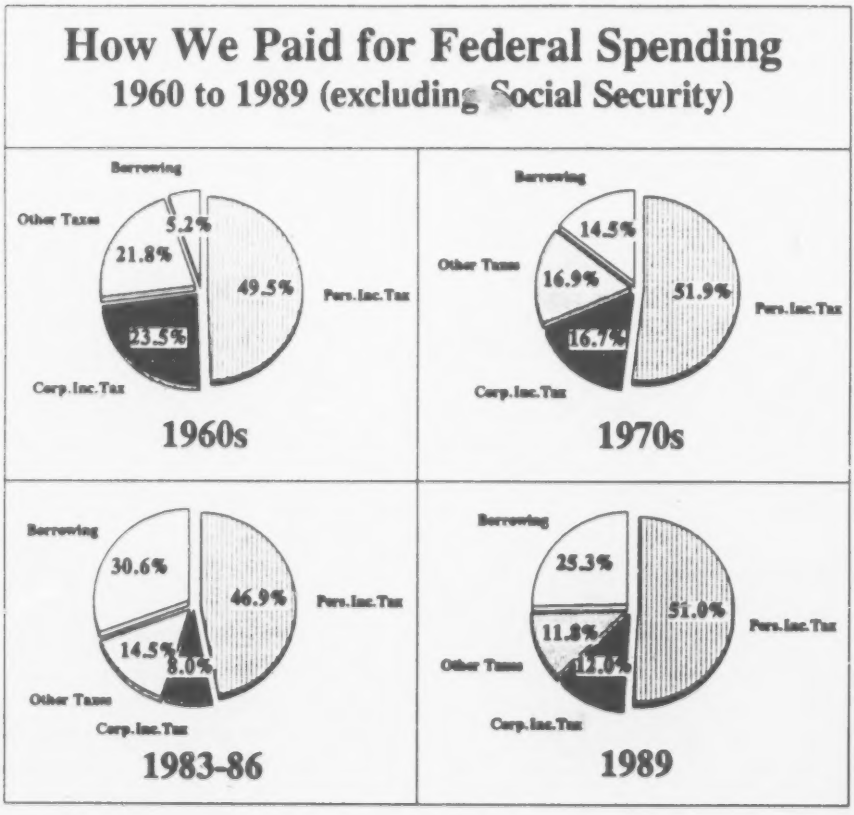
It's hard to imagine raising taxes on 9 out of 10 families yet ending up $70 billion in the hole, but that is exactly what the "supply-side" tax policies of the late 70s and early 80s succeeded in doing.[10]



What To Do

A DECADE AND A HALF of tax policies designed to benefit corporations and wealthy people have come home to roost, creating federal budget deficits of an unprecedented scale.[11] Currently, more than 25 percent of non-Social-Security federal spending is paid for by borrowing—up from just 5 percent in the 1960s. This huge federal demand for credit has led to increased real interest rates and enormous trade deficits, developments which threaten economic growth now and the standard of living of our children in the future.

Our lawmakers will undoubtedly hear from the architects of the policies that have brought us to this sorry state. Some of them will say that nothing needs to be done, that we can continue to borrow and spend without a care for tomorrow. Others will recommend that the burden of



deficit reduction should be borne by middle- and low-income families. And a few will press for even more tax breaks for the wealthy.[12] To choose any of these approaches would violate basic fairness and economic common sense.

We know what lies at the heart of our deficit problem: insufficient revenues—more precisely, the sharp decline in both the corporate income tax and personal income taxes on the richest Americans. And when it comes to revenues, our options are stark. We can continue in the new spirit of fairness and reform reflected in the 1986 Tax Reform Act, which began to stem the flood of tax breaks to the very rich. Or we can search for new ways to raise taxes on middle- and low-income families, who already are suffering from the tax shift policies of the past.

Augmenting the Tax Shift; Repudiating Tax Reform: Sales Taxes & Excise Taxes

Those who are now recommending big increases in federal excise taxes or adoption of a new European-style national sales tax argue that we need tax policies that will discourage consumption. Of course. That is the whole point of reducing the budget deficit—to shift our priorities more toward investment and less toward current spending. But virtually all tax increases, and many kinds of budget cuts for that matter, will have that effect. The real issue is: whose consumption should be reduced?[13]

What we have learned from our experiment with supply-side incentives over the past decade and a half is that tax breaks supposedly designed to encourage private savings and investment have altogether perverse effects. While they caused dramatic and wasteful misallocations of investment and effort, they failed to lead to increases in aggregate savings or investment. Instead, they simply increased consumption opportunities for the well-off.

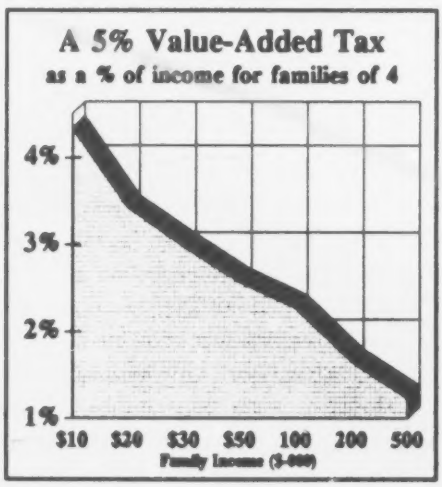
On the corporate side, for example, the huge array of new tax incentives adopted in 1981 failed miserably to lead to added business investment. Instead, the money went into increased dividends, sharply higher pay for executives and a wave of corporate mergers and acquisitions. And, conversely, when many of the so-called "incentives" were scaled back in the 1986 Tax Reform Act, the doomsayers who predicted a full-scale collapse in business capital spending were again proven wrong. Instead, business investment has come back extremely strong following tax reform. After growing by a mere 2.1 percent a year from 1981 to 1986, real business investment, led by investment in industrial

equipment, jumped by 5.2 percent a year from 1986 to 1989. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between tax rates and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

On the individual side, 1981's sharp reductions in tax rates on capital income, hugely expanded tax shelter opportunities and new "incentives" such as expanded eligibility for individual retirement accounts, did not produce the promised surge in personal savings. Instead, savings were merely shifted into tax-favored areas, while the beneficiaries of the tax breaks had more money to spend. The personal savings rate fell to record lows in the mid-eighties, but since the so-called "incentives" were scaled back or repealed in 1986, personal savings has made a comeback, almost back to its historical norm by 1989.

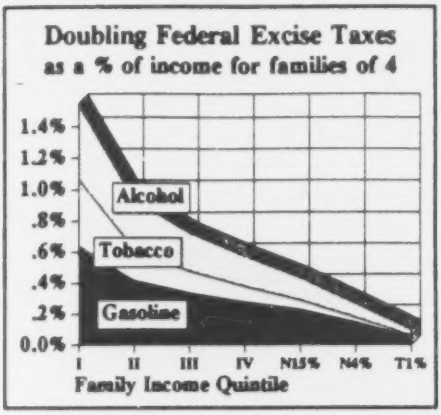
Thus, the question is not whether we want to curb consumption in favor of investment. We do. But do we want to make it a bit more difficult for wealthy people to buy their second Mercedes Benz, or do we want to put Plymouths and Chevrolets out of reach for many ordinary American families? Do we want to make it even harder for first-time homebuyers to achieve their dreams, or to we want to put a crimp in the style of people who buy 50,000-square-foot mansions? Those who push for sales and excise taxes want to curb spending by poor and middle-income families. Those who push for progressive tax changes want to curb consumption by the wealthy. When all is said and done, that is the choice that our nation faces.

Make no mistake about it, sales and excise taxes are inherently regressive. The chart to the right shows the distributional impact of a five percent national sales tax, modeled after the value-added taxes in place in most European countries—which are roughly similar to the sales taxes in most American states. Even with the exceptions these countries provide for many food items, some clothing, health care and some medicines, and most



housing, the poor would pay three times more of their income in added sales tax than the rich would. The tax would cost middle-income families almost twice as much of their earnings, proportionally, as the rich.

Federal excise taxes are, if anything, even more regressive than a national sales tax. The next chart shows the impact of doubling federal excise taxes on gasoline, tobacco and alcoholic beverages. As can be seen, the burdens as a share of income would be far higher on poor and middle-income families than they would be on wealthy people.



Reversing the Tax Shift & Continuing in the Spirit of Reform: Closing Income Tax Loopholes, Raising Tax Rates for the Wealthy

An important lesson of the late 1970s and early 1980s is that showering tax breaks and tax cuts on the wealthy is not good economic policy.[14] But the whole rationalization for the tax cuts for the rich (and tax hikes for everyone else) that were enacted over that period was the "supply-side" promise that such a shift in incomes in favor of the wealthy would boost savings and investment. Recognizing that this approach had been an abject failure, Congress reversed course. The monumental 1986 tax reform act, in particular its corporate reforms, was an important first step toward reversing the tax shift of earlier years. The act took back a quarter of the tax cuts the richest five percent had received in earlier, tax-giveaway bills. It used the money to roll back some of the previous tax increases that had hit most non-wealthy families, particularly the poor. And it made critical structural changes to the tax code to curb tax shelter abuses. But there is still a long way to go if we are to restore the level of tax fairness and progressivity that existed prior to the failed "supply-side" experiment.

According to the congressional Joint Committee on Taxation, the annual cost of corporate loopholes grew from $10 billion in 1970 to $120 billion by fiscal 1986, prior to tax reform. Many of the business

tax breaks, of course, also translated into huge tax-shelter opportunities for the rich. Even after reform, business and investment tax breaks are expected to cost $212 billion in corporate taxes and $205 billion in personal income taxes from fiscal 1989 to fiscal 1993. Moreover, although the 1986 tax reform act significantly curbed upper-income tax shelters, the tax reductions that those shelters previously provided the wealthy were largely retained through the sharp cut in the top statutory personal income tax rate.

In approaching revenue options, we should keep in mind that, on the bottom line, every one percent levy on the incomes of the best-off 10 percent of Americans will add more than $15 billion to government revenues. In contrast, every one percent of income painfully extracted from the poorest fifth of all families adds only $1½ billion a year to tax revenues. If the government is going to ask the American people to make sacrifices to reduce the deficit, it must go where the money is.

The focus of a fair tax-based deficit-reduction strategy should be to continue in the spirit of income tax reform, by closing unwarranted loopholes that remain in the law and by establishing tax rates sufficient both to pay for the cost of government and to stem the rise in inequality in our country. Among the changes we need:

■ **Taxing multinational corporations.** Multinational corporations, whether American- or foreign-owned, are supposed to pay taxes on the profits they earn in the United States. But our tax laws often fail miserably to achieve this goal. In the case of foreign-owned corporations doing business here, IRS data show that:

- √ From 1979 to 1986, the number of foreign-controlled domestic corporations grew by 81%. In constant dollars, their total receipts increased by 55% and their assets jumped by 193%. Meanwhile, however, their reported income fell by 118 percent and their income tax payments dropped by 18%.
- √ Compared to U.S.-owned companies, foreign-controlled corporations reported only half as much taxable income as a share of either receipts or assets in 1986.
- √ In 1986, fewer than 4 out of 10 foreign-controlled domestic corporations reported net income on their U.S. tax returns. This lack of taxable profits was particularly pronounced in the case of petroleum companies (only 1 out of 20 reported net income), auto manufacturers (only 1 out of 8), electronics companies (only 1 out of 7) and chemical companies (only 1 out of 3).

√ In 1986, despite more than $800 billion in assets and more than $500 billion in receipts, foreign-controlled domestic corporations overall reported *negative* net income on their U.S. tax returns, and those that reported taxable income paid a mere $3 billion in federal income taxes.

Meanwhile, in some cases, our tax laws benefit U.S. multinationals, and even provide incentives for American companies to move plants and jobs overseas. To illustrate:

√ In its 1986 through 1988 annual reports, IBM says that about $7½ billion of its $26 billion in total worldwide profits were earned by its U.S. operations. But for federal income tax purposes IBM appears to have been allowed to treat so much of its R&D expenses as U.S.-related that it reported virtually no U.S.-source earnings. As a consequence, IBM's federal income taxes were almost entirely offset by foreign tax credits, reflecting the high foreign tax rates the company says it pays abroad. Of course, it's possible that, notwithstanding what it says in its annual report, IBM really didn't make any money in the United States. But based on IBM's $77 billion in U.S. sales over the three years and its $39 billion in U.S. assets, that hardly seems likely.

√ In its 1987 annual report, and presumably for tax purposes as well, Massachusetts-based Prime Computer said that almost two-thirds of its worldwide profits came from foreign sources. It made this claim even though only 11 percent of its manufacturing and research square footage is outside the United States. The company's incentive to treat its profits as foreign is obvious: because its foreign activities are centered in tax havens, its reported foreign profits are taxed by foreign governments at a rate below 6 percent. A company spokesman told *The Boston Globe*: "We didn't set out to build a plant in Ireland and Puerto Rico, but the government offered incentive and we took advantage and that lowered our tax rate. If that means we paid low taxes, so be it."

We need to overhaul our rules governing international allocation of profits, to protect our tax base and our workers.

■ **Leveraged buyouts and other schemes to replace corporate equity with debt.** The leveraged buyout craze of the 1980s is now costing the federal Treasury more than $20 billion a year—and it threatens to get worse. Strict curbs on interest deductions on debt used to finance acquisitions and other limitations on companies' ability to characterize equity as debt are needed to stem this revenue hemorrhage.

■ **Accelerated depreciation.** Despite tax reform, excessive depreciation on business equipment and real estate is expected to cost the Treasury some $127 billion over the next five years. Buying and selling of depreciation tax breaks remains rampant. We need to bring our depreciation rules more in line with the way assets actually wear out, as evidenced by the depreciation practices used by companies in their annual reports, the length of time property is leased or financed and resale prices.

■ **The Corporate Alternative Minimum Tax.** The new corporate minimum tax adopted in 1986 was supposed to assure that every profitable company would pay a significant amount in federal income taxes. It works well in many cases. But there still are major, profitable corporations in this country that manage to avoid income tax entirely. Several reforms to the minimum tax are needed.

√ Although companies cannot wipe out their minimum tax liability for a given year using loopholes that remain in the regular tax, they can use such tax breaks to generate refunds of regular taxes paid in earlier years. To some degree, this problem may be short term in nature, since companies that routinely owe the minimum tax will soon run out of years with regular tax liability to which they can carry back their excess tax breaks. But the law should nevertheless be changed to disallow carrybacks for any company that owes the minimum tax.

√ Starting this year, the minimum tax will apply to seventy-five percent of an otherwise low-tax company's "Adjusted Current Earnings." In many ways, "ACE" is a good measure of what companies really earn. But ACE should be amended to keep the profits companies report to shareholders as an element (as was the case prior to 1990). Because corporations are reluctant to tell their shareholders that profits are low or non-existent, book income provides an important check on the ingenuity of tax lawyers and accountants. Moreover, 100% of ACE, rather than 75%, should be the base for the minimum tax.

√ The Alternative Minimum Tax rate should be raised to 25 percent.

■ **Tax the *Forbes* 400.** There is considerable evidence that despite the Tax Reform Act, some, perhaps many members of the *Forbes* 400 list of the nation's richest people are continuing to pay little or no federal income tax. Besides raising the AMT rate for wealthy individuals to 25 percent, the tax base should also be reexamined. For example:

√ Every one knows that the combined value of buildings and the land they sit on generally doesn't decline over time; instead, any reduc-

tion in the value of buildings usually is more than offset by an increase in the value of the underlying land. At least for purposes of computing the minimum tax, no deductions at all should be allowed for real estate "depreciation." Developers who actually sustain genuine losses could get a tax write-off when they sell the property—the converse of the fact that they don't have to pay taxes on their gains until they sell.

- √ Many real estate developers have accumulated huge "loss carryforwards" from the super-accelerated depreciation write-offs they were allowed in 1981-86 prior to tax reform. Such dubious deductions should not be allowed in the minimum tax.
- √ A huge loophole that allows developers and others to tap (and spend) their unrealized capital gains without paying any income tax should be closed. Appreciation on a building (or any investment) isn't taxed until it's sold. Borrowing against the increased value of properties is an effective way to take out cash without paying tax. When someone refinances property for more than he originally paid for it, it's clear beyond a doubt that the property has gone up in value. In that case, refinancing should be treated as a taxable realization, and tax should be paid on the gain.

■ **Other income tax base broadeners.** Other areas where the income tax base should be broadened include such things as: restrictions on tax-shelter farming (which creates unfair competition for true farmers), further limits on expense account living, cutbacks in tax breaks for oil and timber companies, curbs on interest deductions on debt incurred to finance acquisitions and stock buyouts, taxing capital gains on inherited property, and strengthening the "mansion cap" on mortgage interest deductions.

■ **Income tax rates.** With a broader tax base, the next step should be tax rates. For starters, the notorious backward bend in the personal tax rate schedule should be corrected. Currently, when the income of a family of four exceeds about $100,000 ($75,000 in taxable income), the supposed top tax rate of 28 percent rises to 33 percent. But when income exceeds about $250,000, the rate drops back down to 28 percent again. Asking truly rich people and corporations to pay a higher rate than the near rich—say 38 percent—would raise more than $30 billion a year for the Treasury.

The proposals outlined above, along with similar income tax reforms, can raise whatever revenues we need to attack the deficit—without adding to the burdens of ordinary American families. Indeed, almost

all the added revenues would be obtained by reversing tax cuts previously granted to the wealthiest five percent of the people—those who can most afford to pay. In addition, these changes would reduce economic distortions caused by current tax policies that sap productivity and long-term growth.

Conclusion

THE FEDERAL BUDGET DEFICIT *IS* A REAL PROBLEM. Excessive government borrowing has soaked up funds that would otherwise have been available for private investment. It has made our nation increasingly dependent on foreign lenders. It has sapped our ability to make the public investments—in education, infrastructure, science and R&D, for example—that we need to assure our future prosperity. And it severely constrains our government's ability to cope with future economic downturns.

Solutions to the deficit problem must flow from a proper understanding of its source. The federal deficit does not come from too much spending—other than spending on interest on the debt. Sure, there are some programs that could be designed better or administered better. There are weapons systems that don't work the way they should and cost too much. These are serious issues. They should be addressed regardless of the size of the deficit. But they are not the root cause of the deficit. The answer lies elsewhere.

The federal deficit does not come from huge tax cuts for middle-class families and the poor. Far from it—as we have seen, ninety percent of American families are paying higher federal taxes today than they did a decade ago. These hard-pressed families, who by and large have watched their wages and incomes stagnate, are not the problem. The budget should not be balanced on their backs.

The federal deficit can be traced, in total, to huge tax breaks granted to the most wealthy Americans over the past decade and a half. These people have watched their incomes and wealth grow by leaps and bounds, even as the nation that defends them, protects them and makes their way of life possible becomes poorer and more indebted by the minute. They are the folks to whom the bill should be sent.

The stakes are high: it's time to stop sacrificing the economic well-being of the vast majority of Americans and our children's future in order to underwrite the conspicuous consumption of the very rich.

ADDENDUM: TABLES

The following table shows the tax changes from 1977 to 1990 for families, by 1990 income levels. It compares what they pay today to what they would pay using 1977 tax rates adjusted for inflation.

Federal Tax Changes, 1977-90 by Family Income Quintile

(adjusted for income changes)[7]

Quintile	Change as a % of Income	Change as a % of Tax	Average Change	Change in $-billions
Lowest	+1.7%	+21%	+$128	+$2.6
Second	+2.1%	+14%	+397	+8.0
Middle	+1.3%	+7%	+409	+8.1
Fourth	+0.6%	+3%	+256	+5.2
Next 10%	+0.3%	+1%	+171	+1.7
Next 5%	-0.2%	-1%	-197	-1.0
Next 4%	-1.4%	-5%	-1,755	-7.7
Top 1%	-15.0%	-36%	-82,196	-84.4
Ave./Tot.	-1.6%	-6%	-$666	-$67.5

The next table shows the changes in real before-tax and after-tax incomes by family income quintile from 1977 to 1990:

Changes in Incomes, Before and After Tax, 1977-90
(in 1990 Dollars)

Quintile	1977 Pre-Tax Income	1990 Pre-Tax Income	% change	1977 After-Tax Income	1990 After-Tax Income	% change
Lowest	$8,933	$7,725	-14%	$8,085	$6,973	-14%
Second	21,171	19,348	-9%	17,862	16,124	-10%
Middle	32,825	30,964	-6%	26,407	24,691	-7%
Fourth	44,152	44,908	+2%	34,494	34,824	+1%
Next 10%	57,016	63,663	+12%	43,355	48,037	+11%
Next 5%	72,653	82,195	+13%	56,474	61,204	+12%
Next 4%	102,406	125,775	+23%	74,870	92,832	+24%
Top 1%	294,874	548,969	+86%	190,446	399,697	+110%
Average	$38,563	$42,114	+9%	$29,823	$32,476	+9%

The next table shows the changes in shares of total income, before and after taxes, from 1977 to 1990:

Shares of Total Income, 1977 and 1990

Quintile	% of Pretax Income		% of After-Tax Income		% Change in Income Share	
	1977	1990	1977	1990	Pretax	After-tax
Lowest	4.9%	3.7%	5.7%	4.3%	-25%	-25%
Second	10.6%	9.1%	11.6%	9.9%	-14%	-15%
Middle	15.6%	14.3%	16.2%	14.8%	-8%	-9%
Fourth	22.5%	21.4%	22.7%	21.5%	-5%	-5%
Next 10%	15.8%	15.2%	15.5%	14.9%	-3%	-4%
Next 5%	10.1%	10.2%	9.8%	9.8%	+1%	+0%
Next 4%	11.8%	12.9%	11.2%	12.4%	+9%	+11%
Top 1%	8.7%	13.2%	7.3%	12.5%	+51%	+71%
Total	100.0%	100.0%	100.0%	100.0%	—	—
Addenda:						
Top 1%:	8.7%	13.2%	7.3%	12.5%	+51%	+71%
Low 40%:	15.5%	12.8%	17.3%	14.2%	-17%	-18%
Top 20%:	46.4%	51.5%	43.7%	49.5%	+11%	+3%
All others:	53.6%	48.5%	56.3%	50.5%	-10%	-10%

Spending & Taxes, 1960s to Present (% of GNP)

	Non-Social Secur. Spending			Non-Social Security Taxes			Social Security	
	Interest	Other	Total	Corp.	Other	Total	Spend.	Taxes
1960s	1.43%	14.95%	16.38%	3.83%	11.67%	15.50%	2.69%	2.82%
1970s	1.74%	14.31%	16.05%	2.67%	11.02%	13.69%	4.52%	4.53%
'83-86	3.19%	14.61%	17.80%	1.43%	10.91%	12.34%	5.77%	5.74%
1989	3.61%	13.18%	16.72%	2.01%	10.53%	12.54%	5.09%	6.39%
1990e	3.70%	13.41%	17.11%	1.87%	10.92%	12.79%	5.10%	6.50%
1993e	3.66%	12.44%	16.09%	1.82%	10.45%	12.27%	4.80%	6.85%

Non-Social-Security Spending in the 1980s (% of GNP):

	Interest	Defense	Other	Total w/o Int.	Total w/Int.
1980	2.09%	5.02%	9.74%	14.76%	16.85%
1982	2.83%	5.90%	9.01%	14.91%	17.74%
1984	3.12%	6.17%	7.90%	14.07%	17.19%
1986	3.41%	6.54%	7.92%	14.46%	17.87%
1988	3.41%	6.06%	7.25%	13.31%	16.72%
1989	3.61%	5.89%	7.29%	13.18%	16.79%

SOURCES: Congressional Budget Office (Feb. 1990). CBO, *The Economic and Budget Outlook: Fiscal Years 1991-1995* (Jan. 1990). Office of Management and Budget, *Budget of the United States Government, Fiscal Years 1990 & 1991, Historical Tables* (Jan. 1989 & 1990). Supplemental medicare premiums are treated as offsetting receipts, and the net cost of the program is included in other non-social security spending.

NOTES:

1. Old Age, Survivors, Disability and Hospital Insurance (excluding supplemental Medicare, which is funded by a combination of participant premiums and general revenues, rather than payroll taxes).

2. Social Security spending has grown from 2.7 percent of the GNP in the 1960s to 5.1 percent in fiscal 1990. Over the same period, Social Security taxes have risen from 2.8 percent of the GNP to 6.5 percent. In fiscal 1993, Social Security spending is expected to total a bit under 4.8 percent of the GNP, while Social Security taxes are expected to be just under 6.9 percent of the GNP.

3. Seen as a government-run pension program, the Social Security system is very progressive, offering considerably better paybacks to those in the moderate- and lower-income ranges than to better-off people. But, as Senator Moynihan has pointed out, to use the Social Security payroll tax to pay for general spending programs is another story entirely.

In 1983, faced with both a short-term and a long-term financial crisis for Social Security, Congress and the president increased the payroll tax rate, raised the amount of earnings subject to the tax, phased in a higher retirement age, and reduced benefits for better-off retired people (by making a portion of those benefits subject to tax). The long-term goal was to build a huge surplus in the Social Security trust fund, to insure that benefits could be paid to current workers when they retire. Although the trust fund surplus is invested in government bonds, that is, lent to the Treasury, the expectation was that this would lead to reduced government debt, lower interest rates, and added productive investment. This, in turn, would increase the income of future generations, and make it possible for them to pay for the benefits promised to future retirees without tax rates becoming too onerous.

Instead of using the Social Security reserves to reduce government debt, however, the Reagan-Bush administrations, with the acquiescence of Congress, continued to run gigantic deficits in the general fund, and used the Social Security surplus to avoid having to take serious action to meet the Gramm-Rudman deficit reduction targets.

Thus, rather than building an investment fund for the future, Social Security payroll taxes are being used to pay for general spending. This is fundamentally unfair. Using payroll taxes to pay for defense spending, for example, is particularly outrageous. Those who have the *most* to protect, that is, the rich, pay the *least* share of their earnings in payroll taxes, because the tax does not apply to wages above $50,000, nor to investment income, such as interest, dividends and capital gains.

By exposing what he rightly calls "thievery" from the Social Security trust fund, Senator Moynihan may have paved the way to move the Social Security reserves out of the Gramm-Rudman deficit calculation, thereby sharply increasing the political pressure to address the real budget deficit problem. At bottom, the government should either live up to the purpose of building up the Social Security reserves, or cut the payroll tax to the level needed to meet current needs and replace the revenues with progressive taxes based on people's ability to pay them.

4. From fiscal 1980 to fiscal 1986, defense spending grew from 5% to 6.5% of the GNP—a 30 percent jump. In fiscal 1989, defense spending amounted to 5.9% of the GNP, still 17 percent higher than in 1980. Over the same period, however, the cost of

non-defense programs (excluding Social Security and interest) plummeted from 9.7% to 7.3% of the GNP, a drop of more than 25 percent.

5. As the chart on page 3 illustrates, federal interest payments have grown from 1.4% of the GNP in the 1960s to an estimated 3.7% in fiscal 1990.

6. *See* House Committee on Ways and Means (WMCP 101-21, Feb. 1990). The data underlying that report and used in this CTJ study are from the Congressional Budget Office. The CBO split corporate profits and corporate income taxes between owners of capital and workers. (Allocating profits and taxes entirely to capital owners—the preferred approach—would accentuate the conclusions reached here.)

7. In comparing the current tax system to the pre-"supply-side" system of 1977, it is important to take account of the dramatic shifts in income levels since 1977. Those whose incomes have increased dramatically since 1977 would have been expected to pay a higher effective rate on that higher income under the 1977 system than they did on their lower 1977 income, because of the progressivity of the 1977 system. Conversely, those whose earnings have declined since 1977 would pay a lower effective rate under the 1977 system than they did on their higher 1977 income.

The comparisons made here take these income-level shifts into account. (They are derived from the CBO data underlying the Ways and Means Committee report.) Thus, for example, for the top one percent of the people, the comparison is between the taxes that are paid on $549,000 in income today and what would be owed on an income of $549,000 (in 1990 dollars) under the 1977 system's level of progressivity—or stated another way, the 1977 system's bottom line adjusted for inflation.

To illustrate this important point, the following table compares 1977 effective tax rates on 1977 real incomes to effective rates on 1990 incomes under the 1977 system adjusted for inflation:

Quintile:	Lowest	Second	Middle	Fourth	Nxt 10%	Next 5%	Next 4%	Top 1%
Change in Real Income, 1977 to 1990:	-14%	-9%	-6%	+2%	+12%	+13%	+23%	+86%
'77 Rates on 1977 Income:	9.5%	15.6%	19.6%	21.9%	24.0%	25.0%	26.9%	35.4%
'77 Rates on 1990 Income:	8.1%	14.6%	18.9%	21.9%	24.3%	25.8%	27.2%	42.2%

NOTE: Still another approach would be to look at how a return to the technical specifics of the 1977 tax code adjusted for inflation (rather than the bottom-line progressivity of the 1977 system) would affect taxes on 1990 incomes. *See* "Statement of Dan Rostenkowski on Tax Progressivity, Income Distribution, and Capital Gains," Exhibit 2 (House Ways and Means Committee, Mar. 9, 1990). While technically intriguing, however, this approach does not capture the inherent progressivity of the 1977 tax system. On the contrary, it anachronistically treats 1977-90 tax avoidance developments [a shift away from more heavily taxed (in 1977) sources of income (corporate profits, dividends) and toward more lightly taxed sources (interest, realized and unrealized capital gains)] as part of 1977's inherent level of progressivity, rather than a trend in the 1980s that contributed to the tax shift.

8. Families in the middle income quintile, for example, saw their real pretax income (in 1990 dollars) fall from $32,825 in 1977 to $30,964 in 1990—a decline of 6%. After-tax income for this group fell by 7%.

9. The decline in corporate taxes reflects a drop in the effective corporate tax rate (taxes paid divided by pretax corporate profits, measured by the sum of taxes paid and taxes avoided due to loopholes, as reported by the congressional Joint Committee on Taxation) from 38 percent in the 1960s to 30 percent in the 1970s to less than 15 percent from 1981 to 1986, and then back up to more than 20 percent currently due to the 1986 tax reform act.

10. Actually, counting the interest on the almost $1 trillion in added national debt built up to pay for previous years' tax cuts for the very wealthy, the total annual cost of the supply-side tax reductions for the top one percent totals $160 billion in 1990.

11. The overall federal deficit—2.9 percent of the GNP in fiscal 1989—would be 44 percent larger were it not for the Social Security trust fund's huge surplus (which is lent to the Treasury and used to offset part of the general fund deficit). The following table compares spending and taxes in fiscal 1969 (the last year the federal budget was in balance), fiscal 1979 and fiscal 1989. (Figures are shares of GNP.)

	1969	1979	1989
TOTAL SPENDING:	19.7%	20.5%	21.9%
Social Security Outlays:	3.2%	4.9%	5.1%
SPENDING w/o SOC.SEC.:	**16.4%**	**15.6%**	**16.8%**
TOTAL TAXES:	20.0%	18.8%	18.9%
Social Security Taxes:	3.6%	4.8%	6.4%
TAXES w/o SOC.SEC.:	**16.4%**	**14.0%**	**12.5%**
Surplus(+)/Deficit(−):	+0.4%	-1.6%	−2.9%
SURPLUS/DEFICIT w/o SOC.SEC.:	—	**-1.6%**	**-4.2%**

12. President Bush's proposal for a restored capital gains tax break, as well as a number of his other tax initiatives, is the most notorious attempt to repeat the discredited tax shift policies of the past.

13. To be sure, deficit reduction needs to be carefully coordinated with monetary policy to avoid making the cure worse than the disease. Without reduced interest rates from the Federal Reserve as part of the package, cuts in the budget deficit could easily lead to both reduced consumption *and* reduced investment.

14. It was not a new lesson. Franklin D. Roosevelt noted in his Second Inaugural Address in 1937, "We have always known that heedless self-interest was bad morals; we know now that it is bad economics."

Chairman SASSER. Dr. Kosters.

STATEMENT OF DR. MARVIN KOSTERS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Dr. KOSTERS. Thank you, Mr. Chairman.

I'd like to be quite brief, but I do appreciate this opportunity to make a few comments.

I'd like to begin by discussing what the evidence indicates to me about what has happened to the average worker's real pay in the 1980's. Then I want to describe briefly how some different groups of workers have fared and what this has meant for the income distribution. And finally I will make a few comments on what this suggests to me for policy.

The first point I want to emphasize is that the average worker has received an increase in total real pay during the 1980's. Total compensation per hour of work has gone up about 5 percent, and cash wage and salary payments have gone up by a percentage point or two.

Now, this is not really a strong performance. It is a better performance than during most of the 1970's. It is poorer, however, than during the 1950's and 1960's. It is also a lot better than a decline in real wages, which is often mentioned in discussions of this matter, and in fact Senator Sasser mentioned this morning that he regarded real wages as having declined since 1982 by some 4 percent. I don't believe that is the case, but I do understand why it is possible to find support for different views on this question.

There are a number of data sources available, and so it is possible to find some data to indicate that workers are losing ground and other data to show that they are gaining ground.

I would like to talk a little bit about those different measures. One reason why the measures show different trends is that they have different coverage. One of the differences in coverage is that some measures include cash wages only, and others include nonwage benefits like health costs and pension costs in addition.

With the growth in these nonwage benefits and the relatively slow growth in overall productivity, especially since 1973, these benefits have crowded out most the of real wage gains that workers would otherwise have had. So it makes a difference whether you are looking at cash wages only or whether you are also looking at wages and benefits combined.

The other element of pay measurement that is important is what types of workers are included. Some series are quite comprehensive; others cover mainly production and nonsupervisory workers.

One of the most frequently cited measures of workers' pay—and I think it is probably the one that Senator Sasser referred to this morning—is a measure of average hourly earnings for production and nonsupervisory workers. I single out this series, which comes from a survey of business establishments every month, because its performance is different from all the other measures that I am aware of. All of the other broad data series also show poor performance during most of the 1970's; but all of the other data series show a turnaround and an improvement in the 1980's except for this one, the production and nonsupervisory worker series.

Why is that? One reason, of course, is that it covers only wages. It does not include nonwage benefits. But the other reason seems to be that it covers workers with a somewhat lower skill mix than is typical for the work force as a whole. There may be other reasons as well, but I think those are the main ones.

What are these other data series? Let me just mention them without going into them in any great detail. First of all there is the compensation per hour of work measure, put together mainly by the Labor Department, which includes nonwage benefits in addition to wages and is more comprehensive, covering pretty much the private work force as a whole. There is also the employment cost index put together by the Department of Labor; it has the great advantage of including both data on wages, cash wages only, and on benefits. It is also very comprehensive in its coverage of workers. I will refer to it later as well.

There are also data from the monthly household surveys, the surveys that we get our unemployment rates from, and I have looked at those. The Social Security Administration also collects and publishes data on wages, and the State employment security agencies develop data that are assembled by the Department of Labor.

Now, all of these series are more comprehensive in their coverage of workers than the production and nonsupervisory workers' wage data are. All of them show an increase in real wages in the 1980's—a relatively modest increase, and a larger increase when benefits are included in addition—but they all show an increase. All this is in contrast to the one series that shows declining real wages, the production workers index.

I conclude from these data that workers have on average received at least small real wage gains. There are other factors that have been at work, of course. The increase in employment has been a good deal larger for women than for men. That has changed the employment mix. Women still receive somewhat lower wages on average than men, and this means if you take men and women separately, each part has done better than the total.

So I think it is really quite clear that for a representative worker, real wages have increased a bit, and wages plus benefits have gone up more during the 1980's.

I want to turn now to differences in wage performance among major groups in the work force. When you look at groups of workers classified mainly along industry lines, you find that workers with the higher pay didn't fare as well as workers with lower pay in the 1980's. Take, for example, goods-producing versus service-producing workers. Goods-producing workers had about a 1.6 percent increase in total real pay compared to about 7.2 percent for those in services.

By 1989, pay in the goods sector was a little over $17 an hour compared to about $13 an hour in the service sector. So the higher wage group fared more poorly during the 1980's. Differences in wage increases of this kind tend to move wages toward more equality.

This is, of course, not the only thing that happened. If you classify workers by broad occupational categories, you find the opposite trend. You find that workers who are paid better did better than

average. For example, if you take white-collar workers compared to blue-collar workers, white-collar workers got a pay increase on average about 8 percent compared to only about two-tenths of 1 percent for blue-collar workers. And blue-collar pay is lower.

This kind of trend has been the dominant one, and it is part of a broader trend. It is a broader trend that Gary Burtless has already referred to, and that is a tendency for people with more schooling and skills to get higher pay increases during the 1980's than those with lower schooling and fewer skills. This is the most pervasive change, in my view, in what happened during the 1980's within the labor market.

The increase in wage premiums for additional schooling has been really quite large. It has pretty much extended across the spectrum of schooling, and it has been applicable both to men and to women.

These wage differentials have all widened, and just to illustrate the size of the change, let me mention some figures. Consider a young male college graduate. In 1980, he earned about 30 percent more than a high school graduate; in 1988, about 60 percent more. This is a big change, a big increase in the additional pay for a person with more schooling. And it is the main source of the increase in wage inequality that occurred during the 1980's.

So instead of saying the rich got richer and the poor poorer, it would really be more accurate to say the skilled and the schooled got richer, and those with fewer skills and less schooling got poorer. And indeed maybe one of the reasons why we see that is because we have had a large increase in immigration, too. Many of those recent immigrants have extremely low levels of schooling, and they also tend to have a language disability. It is not clear that the less skilled and the less schooled fared as poorly in the case of a particular worker as these data seem to suggest. Still, a typical low-skilled worker probably lost ground.

Now, what policies might be considered to improve real wage growth and reduce inequality? The most obvious approach, especially in view of the main source of the increase in inequality, is to improve the schooling and skills of the work force. This is also the approach with the most long-term promise. Better quality of schooling would make a very important contribution.

I should say also, though, that there is a self-correcting element in the labor market. Higher rewards for schooling of the kind that we have seen provide stronger incentives for people to acquire more schooling. Lower wages for people with less skills give incentives for employers to hire them and to train them. So there is this self-correcting element there, and if we could design policies to speed up the kinds of adjustment that we expect to occur naturally, that would be very desirable. The main attractiveness of policies that work directly to build schooling and skills is that they would contribute both to increased equality and to higher growth in wages for the average worker.

We could also consider policies that are aimed primarily at redistributing income. We know, of course, that changes in taxes are not the main source of what has happened to wage dispersion. All the data that I have discussed, and most of the data that Gary Burtless talked about are pretax data. The tax changes may actually have some effect on them; that is, maybe some people report

more income, particularly at the very high levels. But certainly tax changes are not the main source of changes in inequality.

I don't agree with what Gary has suggested—without further data, at least—that government has contributed to less equality in the 1980's. It is true that the average tax rate for the highest income people has declined. But I thought that was the whole idea of the 1986 tax reform, to broaden the base and lower the rates. Both things have happened and the result has been that marginal and average tax rates are lower, but the fraction of taxes raised from higher income people has increased. It seems to me that is what was intended, and that is a result that we should welcome.

As to enriching the earned income tax credit, I believe that it has already been increased too much by the budget and tax actions last year. I think the rates are now too high. The reason is that when the credit phases out, it subjects too many near-poor people to some of the highest tax rates anywhere in the distribution, with the possible exception of some elderly. So I would favor extending the earned income tax credit to people without dependents, but I think the rates have already been increased too much.

Let me conclude by saying that we could consider policies to redistribute more income, and this might have some effects on the after-tax distribution of income. But such a policy would be more likely to detract from than to encourage better wage and income growth.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you very much, Dr. Kosters.

[The prepared statement of Dr. Kosters follows:]

Workers' Pay in the 1980s

Testimony for the
Senate Budget Committee
February 22, 1991

by
Marvin H. Kosters[1]
American Enterprise Institute

It is generally recognized that real wages have increased less rapidly since the early 1970s than during the preceding twenty years. The stagnation in workers' pay has sometimes been exaggerated, however, and reference is often made in popular discussion to declining average real wages. In this review of real wage trends, I examine several measures of pay that are available, emphasizing differences among them in components of pay they include and types of workers they cover.

A careful review of the evidence indicates that the work force as a whole achieved at least a small gain in real (cash) wages during the 1980s, a better result than during the 1970s but significantly below the performance of the 1950s and 1960s. The cash wage paid to a worker is only one component of his total compensation; nonwage benefits, such as health care and pensions, account for another, growing share of the total. For the work force as a whole, total compensation increased 3.75 percentage points more than cash wages during the 1980s. In fact, some groups of workers whose cash wages declined during the 1980s have held their own when total compensation is measured. Reliance on

a single measure of pay, particularly if it describes a group within the work force that is not representative of the whole, can produce a misleading picture of how workers are faring.

Trends in Real Income and Pay

A more accurate and complete picture of what is happening to the American work force can be obtained by examining a number of measures that are available and making careful distinctions about just what each includes. Different measures of pay can lead to quite different conclusions about how well the average worker is doing.

To see how the choices of economic barometers provide different readings, it is useful to look at some of the most widely cited data. The data charted in Figure 1 go back more than 40 years, and they show trends that are more diverse since the early 1970s. They also illustrate the importance of distinctions between partial and more-comprehensive measures -- both in terms of what types of income are included and what groups of workers are analyzed.

These data and those presented subsequently are measures of real economic well-being. They have all been adjusted for inflation using the same price index (CPI-U-XI). Since the main focus of the discussion is to compare trends rather than the amounts of differences among the various measures examined, all are expressed in index form with the indexes scaled to a given year (either 1973 or 1980).

3

The most comprehensive measure shown in Figure 1 is gross national product (GNP) per capita. This measure includes more than workers' pay; it is the ratio of total income produced each year to the total population. In addition to cash wages and noncash benefits to employees, it also includes such items as rents, dividends, and net interest income. Per capita GNP is really a simple measure of the average amount of all that is produced each year and potentially available for distribution to everyone.

As a national average, per capita GNP does not take into account either changes in the proportion of the country's output that is devoted to employees' pay or the proportion of the population at work. Both vary over economic cycles, and that is one reason why the trend in per capita GNP is more uneven than the measures of workers' pay charted in the same figure. The effects of the biggest recessions -- 1958, 1974-1975, and 1980-1982 -- are clearly visible.

In addition to short-term changes, the data also show that changes have occurred in longer-term rates of growth. Although per capita GNP has continued to rise, its rate of increase has been considerably slower since 1973 -- about 1.5 percent per year, compared to 3 percent per year from 1947 to 1973. This is, of course, a much smaller slowdown than for the measures of compensation and wages where the slowdown or actual decline is more apparent.

The next most comprehensive measure charted in the figure is

compensation per hour, which is a broad average of the total cost to employers in the private sector of the economy for wages, salaries, and noncash benefits per hour of work. This measure of total hourly pay for workers employed in the private sector increased at about the same rate as per capita GNP prior to 1973, but since then it increased by less than one percent per year, with most of the divergence from per capita GNP showing up during the 1980s. Compensation per hour is a good measure of what has happened to the total pay of the average private-sector employee in our work force.

The other two series charted in Figure 1 -- average hourly and weekly earnings -- differ in two important ways from compensation per hour. First, they cover only production and nonsupervisory workers. The divergent trends since the 1970s strongly suggest that this less-skilled component of the work force fared less well than the average worker, particularly during the 1980s. The second difference from compensation per hour is that average hourly and weekly earnings include only cash wages. They do not include the nonwage benefits that account for a growing proportion of total compensation.

The source of the difference in average hourly and weekly wage trends is straightforward. Average weekly hours of work for these workers have declined by about one-tenth of an hour per year during the past ten years, from 35.7 in 1979 to 34.7 hours in 1989. This represents a continuing gradual decline for production and nonsupervisory jobs from an average of about 40

hours per week in 1950.

The average weekly earnings series is frequently cited to show that the average worker has lost ground. In judging how he has fared, however, we should take into account a reduction in working hours this measure captures, just as we would want to make an appropriate allowance for increases in earnings that result from a rise in average hours or weeks of work. Thus, the reduction in weekly working hours that moves the trend in average weekly earnings downward exaggerates unfavorable developments for production workers, just as the rise in the proportion of the population at work during the 1980s that is reflected in per capita GNP exaggerates the improvement experienced by the average worker.

Average hourly compensation for the private sector as a whole has increased more rapidly throughout the past 40 years than average hourly earnings for production and nonsupervisory workers. Growth rates slowed for both measures in the 1970s and 1980s, but the divergence in their performance also became much wider. Because average hourly earnings includes only cash wages for production and nonsupervisory workers, it is not clear from these data whether this growing divergence reflects an increasing proportion of compensation devoted to nonwage benefits, poorer-than-average performance for production workers, or other factors. Fortunately, data that enable us to take a much closer look at recent trends are available from other sources.

Wages and Total Compensation

The Department of Labor has developed for its Employment Cost Index information on wages and salaries and on nonwage benefits for a large sample of jobs. These jobs are defined quite narrowly to limit the effects on pay levels of changes in skills of the workers who hold them, and they represent the work force as a whole -- not just production and nonsupervisory workers, who tend to be less skilled. The sample is quite large: in 1989, it included about 21,000 jobs in 4,000 private-sector firms and about 3,500 jobs in 700 state and local government units. Data on wages are available for the years since 1975 and on total compensation since 1979.

The Employment Cost Indexes for wages and for total compensation are charted in Figure 2 and compared with average compensation per hour for the private sector (shown in both Figure 1 and Figure 2). The rise in total compensation shown by the Employment Cost Index during the 1980s is closely comparable to that shown by the hourly compensation series. The correspondence between these conceptually similar measures of total compensation for the average worker is remarkably close, given the completely independent approaches used to gather the underlying information for each.

The cash wage component of compensation shows a small increase during the 1980s. The contrast between this small increase and the decline in average hourly earnings for

production and nonsupervisory workers (shown in Figure 1) suggests that these workers, with generally lower-than-average skills, fared less well during the 1980s than the average worker. Changes in the age, sex, and schooling level mix in the work force are potential reasons for different trends in these two wage measures. But the closely comparable performance of the two compensation measures in the eighties suggests that the difference in wage patterns is not mainly attributable to changes in work force composition.

Trends in Average Wages

The measure of hourly wages shown in Figure 1 comes from a major monthly survey in which payroll information is collected from private business establishments. Information on hourly wages can also be obtained from the monthly survey of households that generates information on employment and unemployment. Federal and state tax records are two other sources of information on wages, although they deal only with wages per person or per job.

Wage indexes based on data from each of these four sources are charted in Figure 3. Each of these measures shows a somewhat similar pattern of decline during the 1970s. But the most striking feature of these wage measures is that all but one show a turnaround in about 1980; the only measure that shows a continuing decline during the 1980s is average hourly earnings for production and nonsupervisory workers (from the business

establishment survey). These data suggest that something changed in the 1980s, and that the change involved slower wage increases for the workers covered by these data than for the average worker in the economy.

The wage series data developed by the Social Security Administration (SSA) and by State employment security agencies (SES) are essentially measures of average earnings per worker instead of measures of hourly pay. Both are quite comprehensive, however, in their coverage of workers.[2]

The better performance shown by the more-comprehensive wage measures apparently reflects in part the larger wage gains of workers with skill levels higher than those of production and nonsupervisory workers. It should be recognized, of course, that production and nonsupervisory workers probably constitute a less-representative, less-skilled group of workers whose performance does not accurately represent what has happened to living standards of U.S. workers. The growth in real wages shown by the SSA and SES series is apparently not mainly attributable to more hours of work per week, perhaps because workers hold more than one job. After a long downward trend, average weekly hours of work reported by respondents in the Household Survey did show a small increase during the 1980s, in contrast to the continuing decline in weekly hours for production workers. However, as shown in Figure 3, average hourly wages for Household Survey respondents increased substantially during the 1980s, even after the longer working hours they reported are taken into account.

Whatever its shortcomings as a wage measure, the SSA series does set annual initial retirement-pay levels. The pronounced difference in trends during the 1980s between the SSA series and average hourly or weekly earnings of production workers raises the question of whether we may be setting initial retirement benefits too high, that is, setting them at levels consistent with stronger gains in real earnings for the average worker than are actually being achieved. Apparently, either workers have on average been doing better than is suggested by the frequently cited production and nonsupervisory worker wage series, or increases in their Social Security payments have been too generous.

Differences Among Groups of Workers

Gains in economic well-being have been uneven, with workers in some kinds of jobs faring much better than those in others. Whether the average working person's economic well-being has improved during the 1980s, and by how much, therefore depends on which workers we consider. Comparisons can be made between percentage changes in wages and salaries and in total compensation for several broad categories of employment, based on data from the employment cost surveys (see Table 1).

Although total compensation as measured by the Employment Cost Index has increased for all groups, white-collar workers fared much better than blue-collar or service workers; nonmanufacturing workers did better than those in manufacturing

industries; workers producing services better than those producing goods; and nonunion better than union workers. Among these groups, blue-collar workers and union workers fared the worst, showing hardly any gain in real compensation during the 1980s. Similar differences are apparent for cash wages and salaries, with the result that real wages alone actually declined for some groups that fared less well. Blue-collar workers and union workers again fared worst, with real wages declining almost 5 percent.

These data illustrate some of the crosscurrents in the labor market. Workers in categories where growth in employment was strongest generally did better than those in sectors where job growth was weak. Virtually all of the job growth during the 1980s, for example, took place outside the manufacturing sector. Wage increases were smaller in manufacturing; however, the average wage level was higher than outside the manufacturing sector. Between sectors classified along industry lines, workers who lost ground had higher pay levels than those whose real wages rose during the 1980s. For example, even though compensation rose by only half as much in manufacturing as in nonmanufacturing, hourly compensation for workers in manufacturing was still about 20 percent higher than for those in nonmanufacturing industries in 1989. Thus, levels of pay for union workers, workers in manufacturing, and in goods-producing industries were still higher in 1989, even though in each case these workers lost ground relative to their counterparts. These

differences in wage adjustments among industry sectors have moved toward equalizing wages.

Other forces have operated in the 1980s to increase wage inequality. Blue-collar workers lost ground relative to white-collar workers, for example, even though white-collar workers receive higher pay. More-skilled workers gained relative to the less-skilled. More-detailed occupational data show that employment growth was concentrated in occupations with higher skill levels, where average pay is higher and real wage gains were larger than for less-skilled groups.

How workers at different skill levels have fared can be examined more generally by looking at workers with different amounts of schooling. In Figure 4, wage trends during the 1980s for workers with a high school education or less are compared with those of workers with at least four years of college. Real wages declined for men with low schooling, and women with the same level of education had only very small gains. Both men and women with college-level schooling, however, had sharp wage gains during the 1980s, a contrast that convincingly illustrates the increasing importance of skills for raising economic well-being.

The larger wage gains for workers with higher levels of schooling in the 1980s has, of course, raised their wages relative to workers with less schooling.[3] This change in the structure of relative wages by schooling levels is apparently the main source of increased wage inequality for working men and women.[4] It is also an important source of the rise in inequality

of family incomes, although changes in the composition of families and in the presence of working members has also had significant effects on the income distribution of families.

Some critics of the wage performance during the 1980s have pointed to a growing proportion of jobs in industry sectors with relatively low wages. What they have overlooked is that workers in growing industries have also had stronger wage growth than those in more stagnant sectors. Critics of the wage performance of workers in relatively less-skilled occupations have disregarded the stronger wage performance of workers with more skills, a group that accounts for a growing proportion of the work force. Contrary to the claims of some who have suggested that the economy offered mainly low-wage new jobs during the 1980s, growing wage differentials between skill levels and schooling attainment demonstrate that demand for skilled workers with high wages was extraordinarily strong. Employers were not offering many low-wage jobs to workers with low skills. They were offering instead a growing proportion of high-wage jobs, at increasing relative wages, to skilled workers.

The markedly different trends in wages for different groups of workers underscore the significance of asking which group should be viewed as representing the typical worker. It is clear that the skills mix of workers has changed dramatically over the years. The typical worker now is much less likely to have fewer than 12 years of schooling and much more likely to have attended college. In 1970, about 36 percent of the adult work force had

not graduated from high school, and only 14 percent had four or more years of college; for workers who entered the work force since that time, however, the proportion without a high school education has declined to only 14 percent and the proportion with college-level schooling has doubled. Workers with low schooling levels, whose real wages have declined, are now less typical. The proportion with more schooling has increased, and their wage performance has been much better.

What the Public Thinks

Another way to judge what has been happening to Americans is to look at how they respond to relevant questions asked in polls. "Would you say you are financially better off now than you were a year ago?" is a question asked in Gallup Polls since at least 1976. The proportion of respondents who answer "the same" or "don't know" has not changed much over the years, but there is considerable variation in those who see themselves as better or worse off (see Figure 5).

During the late 1970s and the beginning of the 1980s, those who said they were worse off exceeded those better off by several percentage points. This was a period marked first by accelerating inflation and then by back-to-back recessions. Economic recovery began in 1983, starting a trend toward improvement. By 1984, those who judged themselves better off exceeded by 15 percentage points those who were worse off, and this margin was maintained or exceeded during the rest of the

1980s. On the basis of their responses, we might conclude that economic well-being improved steadily every year since 1983, when the economy began recovering from the recession.

The pattern of responses to a related Gallup question in which respondents were asked whether they expect improvement for the year ahead is quite similar over time. Pessimism was prevalent in the late 1970s, followed in the early 1980s by growing optimism. Indeed, the margin of optimism throughout the 1980s was far wider than for judgments about how they fared over the past year. In 1988, for example, the optimists exceeded pessimists by 52 percentage points, with only 9 percent expecting to be worse off next year and 17 percent expecting no change.

Looking farther into the future, 74 percent expected to be better off by the year 2000, compared to about 60 percent who expected to be better off in the year ahead. These longer-term expectations are not necessarily inconsistent with annual experience, because the cumulative effects of year-by-year improvement for a substantial majority can be quite positive over a decade.

As a measure of improvement in economic well-being, information from attitudinal polls has serious shortcomings: responses may be subjective, and people may be better off financially for a variety of reasons. They may be working more, for example, or they may be getting more income from sources other than wages. Yet both the margin of positive responses during the 1980s and their pattern over time are

broadly consistent with the data on real wages and compensation for the average worker. The public is apparently quite capable of judging whether the economic news is good or bad.

Concluding Comments

America's work force has grown by almost 50 percent over the last 20 years; proportions of males and females working, new levels of schooling and skills, and industries and occupations themselves have changed dramatically. For workers who have attained higher levels of schooling, pay levels have increased significantly.

There is no doubt that the average worker's lot has improved. After taking inflation into account, wages and benefits increased. On average, real cash wages increased for the work force as a whole, although by only a small amount and not for every major group. Responses to the popular polling question "Are you better off?" are largely borne out by the statistical evidence: 44 percent say their situations have improved, compared with 28 percent who say they are worse off.

The causes of changes in wage patterns are not well understood. There is still no consensus among analysts about why productivity and compensation are increasing at a slower rate since the early 1970s, for example. Although changes in wage relationships during the 1980s have been examined to look for their underlying causes, it is not clear why skill differentials have increased so much in such a short time. Careful analyses

have not found close or significant links between recent wage and income trends and national policies.

Even though changing wage patterns cannot be closely traced to any specific national policies, it is nevertheless appropriate to consider what actions could counter these patterns, mitigate their effects, or facilitate adjustment to new conditions. Policies to encourage upgrading schooling and skills would make the most general contribution to both raising real wage growth and promoting more equal distribution. Increased investment in human capital would improve the skills and earnings of the workers making such investments, and improving the skill mix of the work force would help to raise the relative wages of those whose schooling and skills remain low.

The main source of increased wage inequality during the 1980s -- wider wage differentials between workers with different schooling levels -- is important because it has implications for future developments. Increased schooling wage premiums represent short-term adjustments to skill demands, and these higher schooling wage premiums can be expected to give rise to self-correcting changes. High economic returns to schooling, if expected to persist, will bring about adjustment in relative supplies as young people have greater incentives to acquire more schooling. Trends in college enrollment rates, for example, have been positively related to schooling wage premiums. More emphasis on job-related training represents another way of increasing skill supplies. Their lower relative wages make

hiring workers with less schooling more attractive to employers if prospects for training such workers are sufficiently favorable to enable employers to recoup their costs of investments in training. Policies that might encourage more rapid adjustments along these lines might be useful both to reverse the trend toward increased wage dispersion and to enhance investment in human capital.

The wage and compensation data that have been discussed are all before-tax measures. Tax policies could be designed to reduce inequality after taxes, even though changes in inequality during the 1980s were apparently not mainly attributable to changes in tax policy. Tax policies aimed at redistributing income, however, are more likely to impair than to improve human capital investment and income growth.

Federal tax changes during the 1980s have included both reducing marginal income tax rates (combined with eliminating many loopholes) at the high end and taking many at the low end off the income tax rolls entirely. Although Social Security taxes have increased, the earned-income tax credit has provided refunds to many low-income people with dependents that offset not only their own but most of their employers' contributions. Indeed, the recently enacted increases in the earned-income tax credit bring refunds that far exceed total federal tax payments for many eligible workers. Some redistribution is feasible through tax changes, but no conceivable tax policy could raise the average worker's after-tax real income and at the same time

reduce the already wide gap between federal tax revenues and spending. Only producing more real income can do that.

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Endnotes

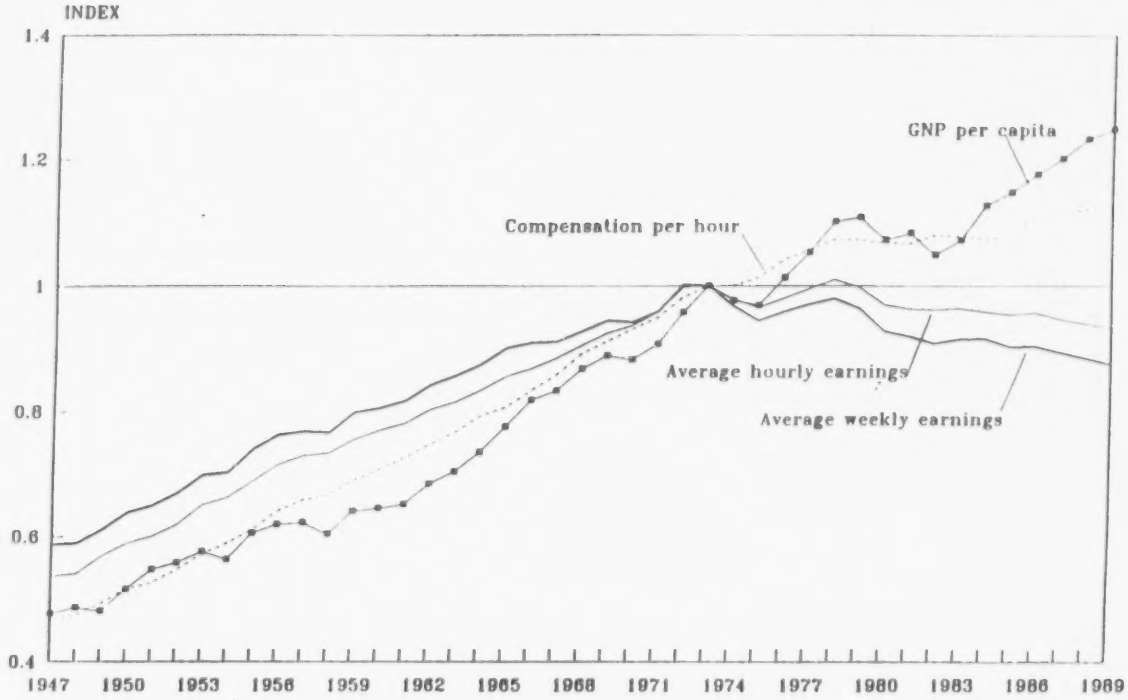
1. Director of Economic Policy Studies at the American Enterprise Institute for Public Policy Research. This testimony draws heavily on my article published in the January/February 1991 issue of The American Enterprise.

2. These data were presented in an article in the Wall Street Journal (August 21, 1990) by Robert J. Myers. The view they supported -- that real wages increased in the 1980s -- was strongly criticized in an editorial in the Journal of Commerce (August 23, 1990). In an article in the Washington Times (September 3, 1990), however, Warren Brookes argued that the SSA data are a more reliable measure of the average workers real wages than the production and nonsupervisory workers data from the establishment survey.

3. The pronounced increase in wage premiums for additional schooling that emerged in the 1980s is documented in more detail in Marvin H. Kosters, "Schooling, Work Experience, and Wage Trends," American Economic Review, May 1990, Volume 80, Number 2, and in several other recent studies.

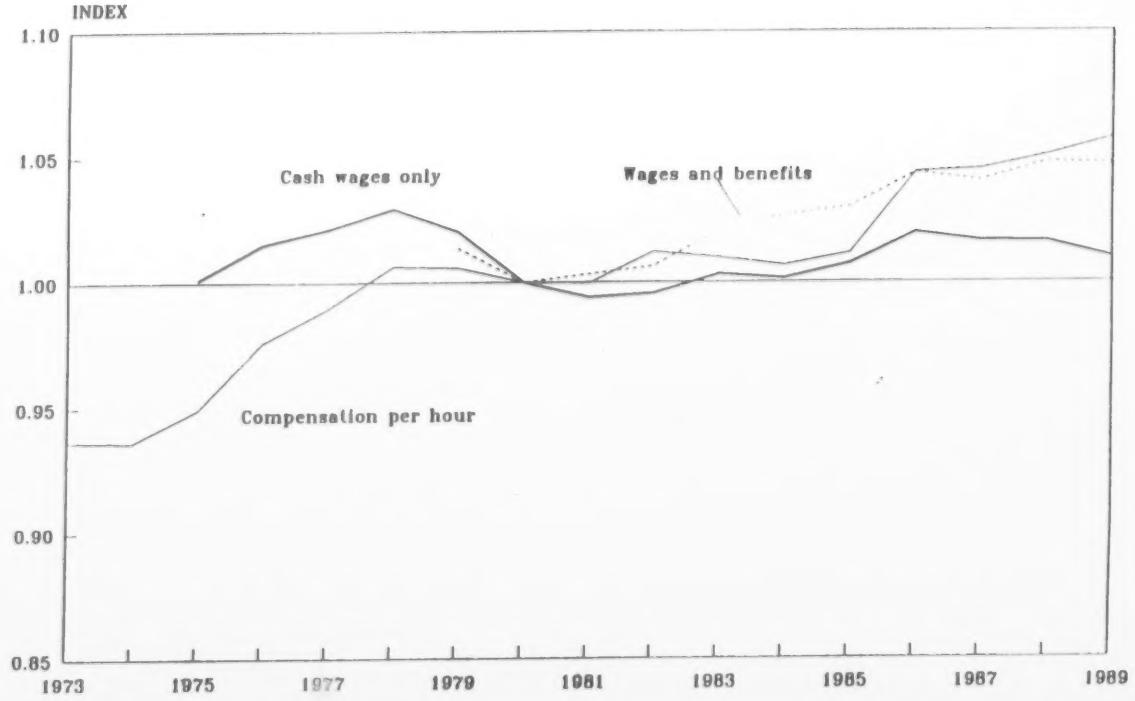
4. In his analysis of changes in dispersion in real earnings, Avril Bamezai concludes that the rise in inequality began before the 1980s and that increased demand for skilled workers associated with technological change has produced changes in the structure of wages. These changes in wage structure -- the rise in relative pay for workers with more schooling -- account for almost all of the rise in earnings dispersion during the 1980s. See Avril Bamezai, "Rising Earnings Disparity and Technological Change," The RAND Corporation, Santa Monica, CA (December 1989).

FIGURE 1
HOW WORKERS HAVE FARED: TRENDS IN REAL MEASURES OF PAY (1947–1989)



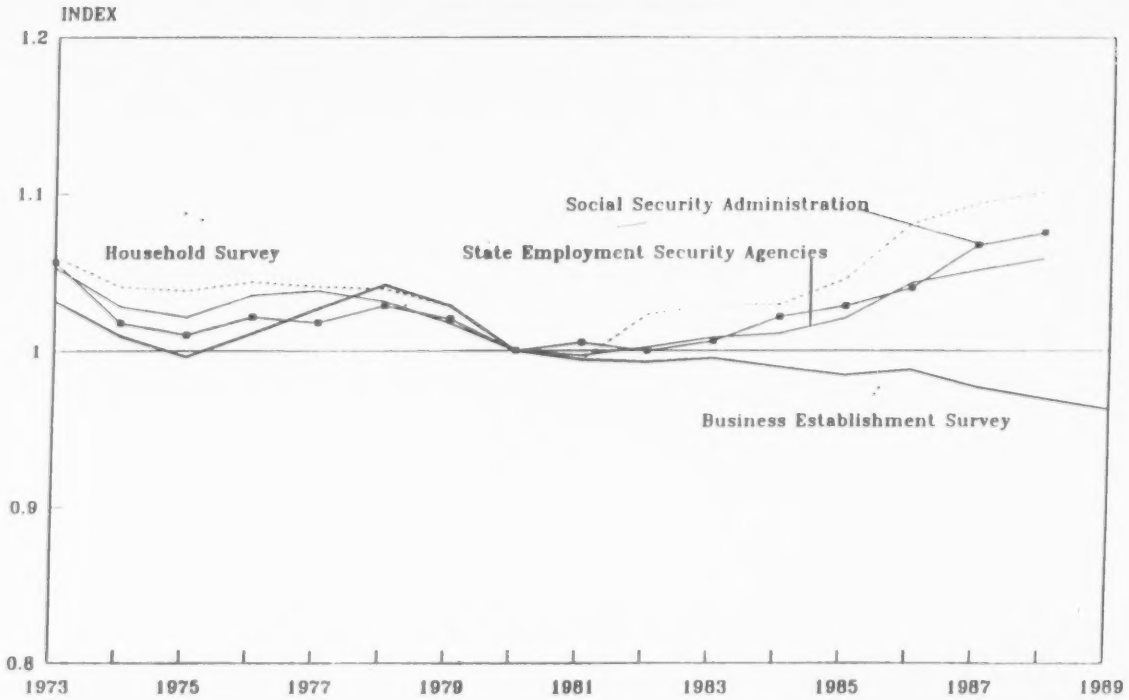
SOURCE: Bureau of Labor Statistics; *Economic Report of the President*, 1990

FIGURE 2
REAL HOURLY PAY IN THE 1980s: CASH WAGES ONLY VERSUS WAGES AND BENEFITS COMBINED



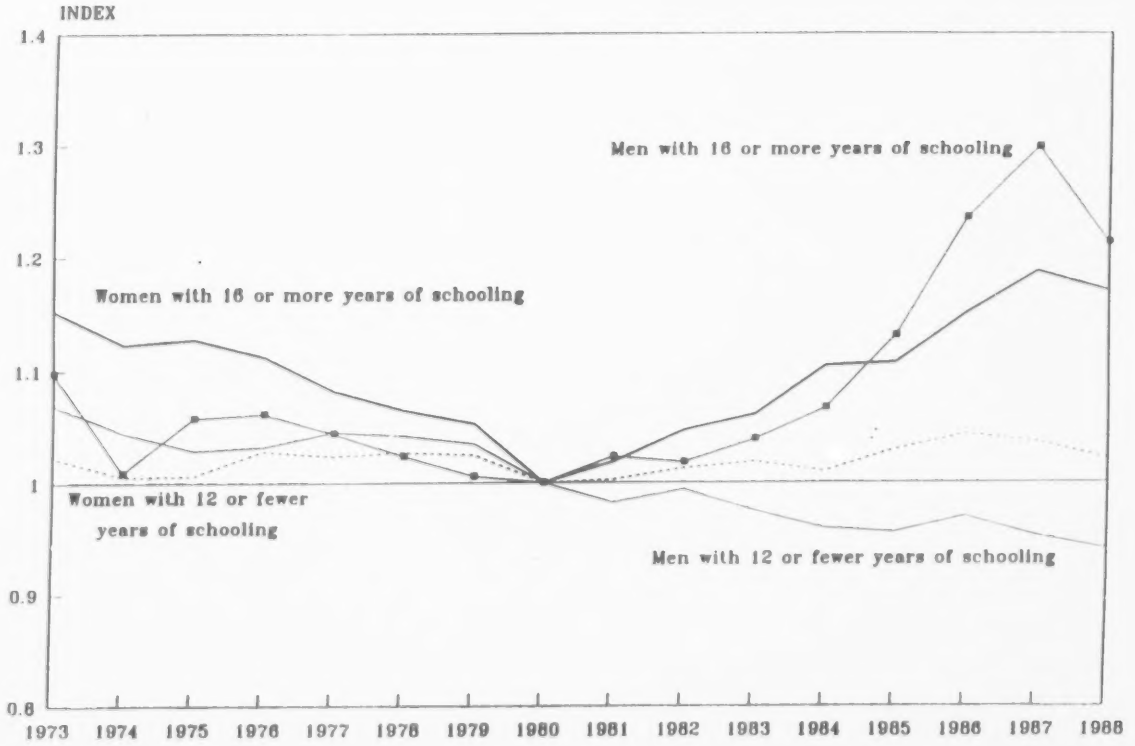
SOURCE: Bureau of Labor Statistics

FIGURE 3
AVERAGE REAL CASH WAGES:
MEASURES FROM FOUR DIFFERENT SOURCES



SOURCE: Bureau of Labor Statistics, Social Security Administration, author's calculations from CPS microdata

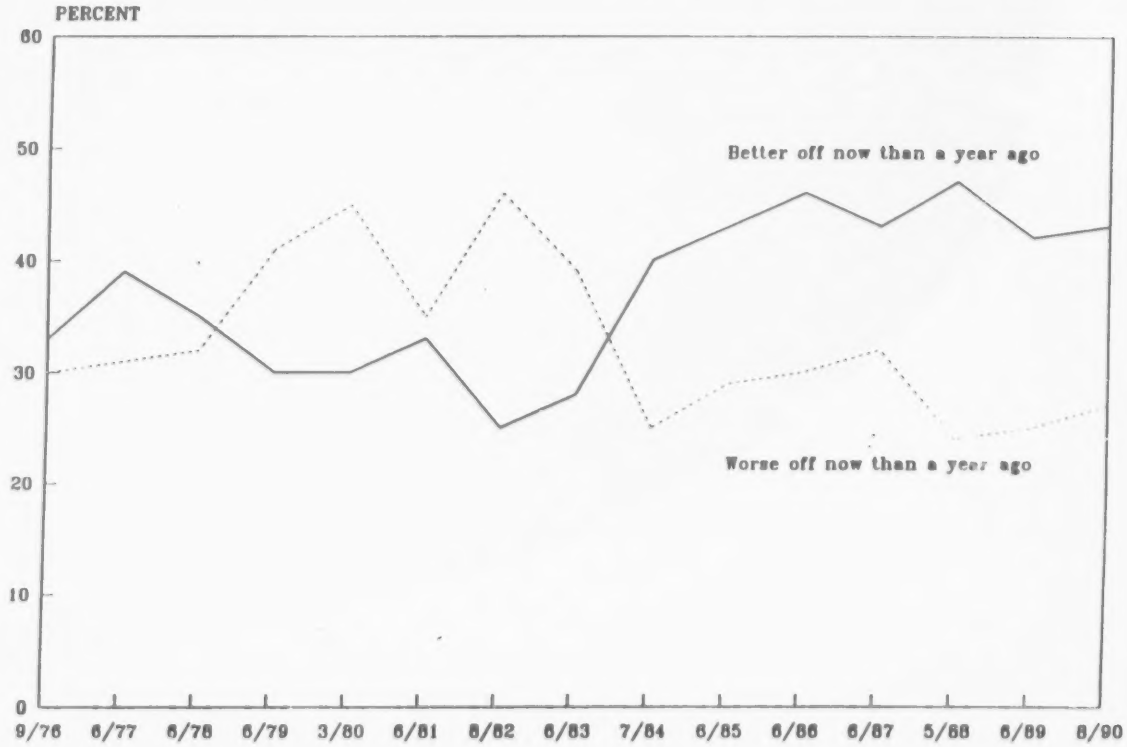
FIGURE 4
REAL HOURLY WAGES BY SCHOOLING AND SEX



SOURCE: Author's calculations from Current Population Survey microdata

FIGURE 5

PUBLIC PERCEPTIONS OF FINANCIAL WELL-BEING



SOURCE: Surveys by the Gallup Organization, latest that of August 15, 1990

TABLE 1

Workers' Pay by Major Sector: 1980-1989

	Total Compensation	Wages & Salaries	Compensation Level 1989
	(Percent Changes: 1980-89)		
All Private Industry	4.7%	0.9%	$14.28
White Collar Occupations	8.1	5.1	16.57
Blue Collar Occupations	0.2	-4.6	14.35
Service Occupations	5.6	0.1	7.16
Manufacturing Industries	2.6	-1.9	17.16
Non-Manufacturing Industries	5.8	2.5	13.46
Goods Producing Industries	1.6	-2.8	17.21
Service Producing Industries	7.2	3.9	13.12
Union Workers	0.7	-4.7	18.25
Non-Union Workers	6.1	2.9	13.48

Source: Employment Cost Indexes and Levels, 1975-89, U.S. Dept. of Labor, Bureau of Labor Statistics, October 1989; Bulletin 2339

Chairman SASSER. Mr. Burtless, you indicate in the Brookings wage study that historically the less affluent tend to do relatively better during good economic times than the more affluent. I'm talking about relatively speaking, the less affluent do better when times are good than the more affluent.

During the most recent economic expansion, other factors precluded the income gap from narrowing; in fact, you pointed that out today in your testimony.

The income equality gap widens significantly in figure 4, I believe, when we look at your testimony, during our recent supposedly good times. The country is now in the middle of some bad times, and instead of stemming the inequality tide, the business cycle is now going to add to it. It appears to me that the less affluent are in sort of a lose-lose proposition, judging from your testimony; they did not get the rise that they should have gotten in the so-called good times of the 1980's, and now they are going to lose even further as we move into worse times.

Why was the expansion of the 1980's atypical? Why did the less affluent not gain, relatively speaking, as they have done in other good economic times? Why did they not gain on the more affluent?

Mr. BURTLESS. Well, the main reason that the less affluent families gain when economic times get better is that the lower unemployment rate tends disproportionately to raise their earned income. They gain because more of them become employed, and because those who are employed enjoy faster wage increases than the rest of the work force. That is historically what happened until the late 1970's. Over the recovery of the 1980's wage rate gaps among men did not fall during the recovery; they got wider. I think this is due to this trend that both Marvin Kosters and I mentioned that apparently the rewards to unskilled labor have really tumbled in the labor market.

You might ask why that has occurred, and we can have a discussion about it, but I think that is the decisively important factor.

Second, marriage patterns have changed in the 1980's in a new and different way. I'm not talking about single-parent families because the number of those has been rising fairly steadily since the late 1950's or early 1960's, so that is not new. But what is new, apparently, is the association between the wages earned by a man and a wife in the same family. It seems as though the increase in labor force participation, employment and earnings of women in the last 10 or so years has been especially concentrated amongst households with fairly high incomes, and that is relatively new.

We don't know a priori whether women having more earnings will reduce income disparities or increase them. I think that in the 1950's and 1960's, increases in earnings among women probably reduced income inequality because the women who first tended to go out and get jobs and become employed and raise their earnings were women who were in less affluent families. That is one of the reasons they went out and earned income.

In more recent times I think there is a social phenomenon that every woman in society feels as though she should have a role in the labor market, that it is an important part of her life, and that disproportionately affects the most affluent families, which were

the ones that did not need the income of a second earner earlier on.

Chairman SASSER. Well, before the recession hit, we heard over and over again about record economic growth and the expansion that occurred between 1983 and 1990; it was called the largest, longest peacetime recovery in our history. I'm not sure I agree with that, but that's what everybody said. Compared to the depths of the 1982 recession, which was the deepest one of the entire postwar era, at the end of this 8-years of the longest "peacetime expansion"—put that in quotes—in the history of our country, was the average American worker better off 8 years after the expansion than before?

Mr. BURTLESS. I think it would be useful to divide American workers into four different groups: women, of better education and of less education; men, of better education and worse education. For three of the groups I believe the situation of the workers is better off. Now, having said that, I should say that their earnings gains are a lot lower than they were before 1973, but nonetheless they are better off at the end of the economic recovery than they were at the beginning of the recovery. For less skilled men, I think the evidence is overwhelming that they are doing less well in 1991 than they were doing in 1983. Their employment prospects seem to be worse; more of them have dropped out of the labor force; their unemployment rates remain relatively high given the overall rate of unemployment, and the weekly wages that they take home from work are lower than they were at the beginning of the recovery.

Now, some people argue that the money wages received by these men do not tell the whole story; instead we have to look at the compensation that they receive. But I'd like to remind those people that compensation measures what employers pay for an hour of work, not what workers receive from having worked that hour. Lots of the increase in the compensation to moderate earning men has gone to higher social security payroll taxes, and higher premiums for health benefits that are actually no more generous at the end of the 1980's than they were at the beginning. Taking all of that into account, I think it is very likely that men at the middle and below are worse off at the end of the recovery than they were at its beginning, and that is extremely unusual for any kind of recovery, especially one that long.

Chairman SASSER. Well, you have not only clarified, but I'm going to turn the questioning over to you, Senator Domenici, at this juncture.

Senator DOMENICI. Thank you, Mr. Chairman.

I want to say to you I had some serious doubts about how much we'd get out of these hearings when you first scheduled them. Frankly, I don't know that this is exactly the right panel—maybe two more, or one different. But in any event, I think it is good for the committee to hear these kinds of experts on the American economy.

I really worry that those who are going to make the tax policy and the other policies by writing the laws sometimes do not get the benefit of this. And we hear it, but we can't do a lot about it. We can set targets and goals. So I thank the three of you for your testimony.

Let me ask you, Mr. Burtless, you were about to say something about the importance of boosting long run economic growth when your time ran out. Do you recall that?

Mr. BURTLESS. Yes.

Senator DOMENICI. Could you expand on that thought a bit?

Mr. BURTLESS. Well, I agree with Marvin Kosters and with your opening statement that in the long run really the best source of help for people who are struggling, whose incomes are not rising very fast, is to boost the overall rate of productivity growth. And since, like Marvin, I think a lot of the problems are concentrated amongst the less skilled, we should really try to change our policies in ways that help less skilled workers. And I think the two principal components of that help in the long run will have to come from improvements in the education system, particularly for non-college-bound youth and from changes in the incentives that we provide to employers to help their less skilled adult workers accumulate more skills so they can compete with workers, whether in Japan or in Mexico.

The kinds of reforms that I would favor for education would require that school systems teach a number of skills that can be certified as being accomplished by students, especially non-college-bound students; that national tests of these skills be established and recognized by employers, who then can use them in selecting their work force, selecting the children who tried the hardest in school, to reward these non-college-bound youth for their efforts when in school.

For adults, I'm not really sure how we can provide better incentives for employers to invest in their workers. But I think we can certainly try to change the tax code in a way that does not discourage long-term relationships between a firm and its work force but instead encourages greater rewards the longer this relationship between a worker and an employer lasts. The longer an employer expects the workers will remain in their work force, the greater that employer will feel the payoff would be from investment and training in that worker.

Senator DOMENICI. Thank you very much.

Mr. McIntyre, you had discussed the period from 1980–85, before the recovery began. From the standpoint of looking at the tax cuts that occurred, you spent some time talking about supply-side economics in your way. You, you did not mean, did you, in any of your testimony here today about economics that if you just tax some part of America that that makes for better economics, whether it is the extremely rich, or corporations? By itself, does that make for a stronger, more vibrant economy, just the act of taxing it?

Mr. MCINTYRE. I think that not running the large deficits of the 1980's would have been good for the economy, yes, Senator.

Senator DOMENICI. But I didn't ask that question.

Mr. MCINTYRE. Well, in other words, to avoid the big deficits, you would have had to have had higher taxes or lower spending; you would have had to cut someone's private income in order to balance the budget or get it closer to balanced. So yes, I do think that higher taxes would have been good for the economy.

Senator DOMENICI. All of your hypotheses about who should be taxed at what level are based upon the fact that you think there is

a higher need for the government to use that money than for the entity that earned it, corporate or individual. There is some other thing in the system—we've got to pay some bills or we've got to provide a program; otherwise there is no economic benefit to taxing, is there?

Mr. MCINTYRE. Well, the alternative to taxing is borrowing, and certainly that's what the Government did in the 1980's. I thought that was a bad strategy, but it was an articulated strategy; it was not an accident.

Senator DOMENICI. I understand what you are saying. You supported the tax reform measures personally, and the organization you represent did; is that right?

Mr. MCINTYRE. In 1986?

Senator DOMENICI. Yes.

Mr. MCINTYRE. Absolutely.

Senator DOMENICI. So anything you said today about that had to do with the previous across-the-board cuts, not the Tax Reform Act; is that right?

Mr. MCINTYRE. When it comes to the 1978 and 1981 tax acts, I am bipartisan in my dislike for those two bills, Senator.

Senator DOMENICI. Well——

Mr. MCINTYRE. Seventy-eight was when Jimmy Carter was President; 1981 was the Ronald Reagan tax bill, primarily corporate cuts. And since then Congress has been trying to undo its mistakes. I know you have been involved, and I appreciate your efforts as much as anyone else.

Senator DOMENICI. But the 1981 tax cut was not Reagan's or Republican.

Mr. MCINTYRE. It certainly enjoyed bipartisan support in Congress; there is no doubt about it.

Senator DOMENICI. Yes; I just took a look this morning, and it had enormous support from both parties.

Mr. MCINTYRE. Yes; but the President proposed it, and most people would call it "the Reagan tax cut."

Senator DOMENICI. And indeed you recall the extreme discussion going on between House and Senate, and actually the democratically controlled House added more tax cuts than were proposed at one time; isn't that true?

Mr. MCINTYRE. There was a bidding war in which B'rer Reagan kept getting thrown in the briar patch and coming back out begging for more, yes, Senator.

Senator DOMENICI. As you analyze from the economic side the tax policy that you see that was good for the country and what happened in 1979, 1980, 1981, 1982, do you ever refer to the activities of the Federal Reserve Board as having anything to do with what happened to the American economy, or is it taxes and deficits?

Mr. MCINTYRE. No; I think the Federal Reserve Board is absolutely the key, but it is consistently responding to the fiscal policies set by the Congress. In fact, getting out of the 1982 recession was begun when the Fed loosened up in response to the 1982 tax increase bill.

Senator DOMENICI. Well, I think what happened there was the Federal Reserve decided that they were going to cure inflation, so

they did it long enough to make sure it was all out in their opinion, and then they decided to loosen up the money. I think that was the prime motivation. And one would ask why would they do it, and I don't have any doubt that they didn't do that because we had cut taxes; I think they did that because of something that occurred in this economy in 1979 and early 1980. But maybe you think differently.

Mr. McINTYRE. The Fed's decision to loosen up in 1982 was, I think, to a large degree a response to the fiscal policy change——

Senator DOMENICI. No; I was ahead of you. I said when they put it on, not when they took it off.

Mr. McINTYRE. Yes; that was another Jimmy Carter appointment, and it did get rid of inflation, I suppose, at great cost.

Senator DOMENICI. That was Paul Volcker.

Mr. McINTYRE. Yes.

Senator DOMENICI. Reagan kept him on a while, too, didn't he.

Dr. Kosters, let me thank you for your testimony and tell you that I don't have sufficient time to understand all of these various places you look for information, but I have a great suspicion that you can find almost anything you want to find, and that is why I opened with my remarks. And you have just in a very academic way told us six or eight different things you can look at and you'll get different results on who benefitted from what. There has been a lot of talk that the service jobs in the United States, whatever that means. I'm fully aware we have not yet defined them and I'm fully aware that we're not sure we know how to figure productivity in some of them. But people say America is becoming a service-oriented country, and that's bad. The jobs are bad, no wage increases in them, and they are menial. Is that true?

Dr. KOSTERS. It is true that we are becoming a more service-oriented economy. I don't think that is bad, and I don't think that most jobs there are bad. It is true that if you look at service-producing industries compared to goods-producing industries, average wages are lower in the service-producing industries. However, within the service-producing industries, as well as within the goods-producing industries, the more skilled occupations have grown in numbers, and wages in those jobs have increased more rapidly than the average.

So I think it is more instructive to look at occupations rather than at industries to examine whether most jobs have been "good" and whether "good jobs" have grown. I very much agree with Gary that the problem is not too many "bad jobs." Too much demand for low-wage workers didn't make their relatively wages decline. The opposite occurred instead.

Senator DOMENICI. The last question has to do with my own notion of things. When people refer to the goods side, the goods and production side of the American economy, and in their own way refer to the "good old days"—I guess the "good old days" would be the 1950's and 1960's—I think both of you in your own way have said that was a period when wage growth in that part of America was dynamite. Now, we look at the current period, and we say it isn't as good. My notion is that the reason it was extremely good then was not because we had wonderful tax policies, great fiscal policies, but rather that there was no competition in the world.

Whatever Americans produced, more or less, at least through the 1950's, we bought. We produced lemons as cars, with big fins, and we bought them anyway. For part of the time the world bought them because there wasn't anyone else around. And part of the time they bought our steel, whatever its price.

Is there any merit to this notion that that is why those kinds of wages started coming down and why we're going to have a difficult time getting them back up because there is plenty of competition in the world?

Dr. KOSTERS. I think increased competition in world markets has had an effect on wage structure during the 1980's. But I would have to admit to you that I don't think I or any economist I know has a good explanation of the decline in productivity growth, the decline in real wage growth that we have experienced since the early 1970's. I just don't think that there is a consensus on the causes. If we knew why it happened, we might be able to make better suggestions about what might be done about it.

Senator SIMON [presiding]. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Senator Domenici, I appreciate your statement this morning and the line of questioning. I think some of the work you are doing is going to be very interesting for all of us who are interested in this subject.

Mr. Chairman, I think it was some 50 years ago when someone said something to the effect that if a lie is repeated often enough, it becomes indistinguishable from the truth. My memory is that that was Joseph Goebels, who was the minister of enlightenment and education for the Nazis. I think that statement says a lot about how we got to where we are and how conventional wisdom is sometimes arrived at in this town. Before long, if a story is told often enough, pretty soon unsuspecting Senators start repeating it, thinking it is the truth when in fact it is not. They are saying things that they actually believe to be the truth.

Mr. McIntyre, you state in the second paragraph of your testimony that since 1977 the rich have gotten richer as their taxes have shrunk, while the incomes of the middle- and low-income families have stagnated or fallen as their taxes have risen.

Now, if you are a baseball player that might not be too bad because of the four assertions, you got one right—the rich have gotten richer. But to argue that their taxes have shrunk is absurd.

It is even harder to see how you can argue that the poor have seen their taxes increase. In 1988, 22.8 million tax filers paid no income taxes, and 99.3 percent of these people had incomes under $20,000. A family of four with an income under $11,500 pays no tax, neither income nor social security, thanks to the Earned Income Tax Credit. In fact many of these families qualify for a cash refund.

Now, it is going to take some extremely creative manipulation of the statistics to overcome these facts, and that doesn't count what we did with last year's budget bill. According to the Joint Committee on Taxation, this year's family earning less than $10,000 will enjoy a 2-percent cut in their overall Federal tax burden, while those earning between $10,000 and $20,000 get a 3.2-percent cut in taxes. Every other income group is hit with a significant tax in-

crease, particularly those with incomes above $200,000. Those folks get a 6.3-percent increase.

Just to complete the picture, according to Joint Tax, those with incomes below $10,000 face an effective tax rate of 13.1 percent. The effective tax rate increases progressively through income levels until it reaches a rate of 26.8 percent for taxpayers with incomes over $200,000. The rich, therefore, pay over twice the tax rate as the poor. These figures include the social security tax, which I think it is fair to argue is regressive. Now, that may be the only other thing we agree on.

Given your concerns, Mr. McIntyre, over the progressivity of the Federal tax system and the regressivity of the social security tax system—not talking about the payout but the pay-in—I wonder if you agree that the payroll tax ought to be reduced, as Senators Moynihan and Kasten have argued?

Mr. MCINTYRE. That's a very long question, Senator. I'll answer the last one first. I think if you wanted to cut the payroll tax on average workers, perhaps by raising the wage base for the tax, perhaps by raising some other tax——

Senator SYMMS. No; I'm just asking directly do you favor the Moynihan-Kasten bill to reduce payroll tax?

Mr. MCINTYRE. Absolutely not. I don't think borrowing money from the Japanese to give to American workers is a good idea. I do think American workers could use some more money.

Senator SYMMS. I'm short of time. I want to go to Mr. Burtless.

You state in your testimony that income growth has slowed down for one main reason—the pace of productivity improvement has declined. Now, this statement involves two difficult things to measure—income growth and productivity improvement. You can look at the matter another way, and one way which I think we can all agree, which is that one of the surest ways to improve income growth is to improve productivity.

There are thousands of ways to improve productivity, but the main ones can be grouped, in my opinion, as follows: Improve education, so you have a smarter work force, and they will probably work better; new technology in both product and production; and increasing investment so the work force has more and better capital to work with. Focusing on the last two, because these are most affected by taxation, it seems to me that we can only get more investment in R&D and more investment in plant and equipment if we increase their after-tax returns. One of the best ways to do that is to reduce taxes. So I guess my question, Mr. Burtless, is wouldn't increasing taxes particularly on businesses and corporations tend to discourage investment, thereby further reducing improvement in productivity necessary for strong income growth?

Mr. BURTLESS. Well, that was the theory that we operated under in 1981, and I'm afraid the returns from that experiment are not terribly hopeful for the proposition. Net investment as a share of net national product has declined over the 1980's in comparison to all the previous postwar decades. So evidently, the effect of the microtax incentives for greater investment on the part of individuals and firms has been offset by the fact that real borrowing costs in the 1980's were so much higher than they were in previous decades. So the two seem to offset each other.

We had a gain—I think you are right; if you raise the aftertax returns, it does produce an inducement for people to invest. But the way we did it, of course, was for the Federal Government to borrow money that formerly it had raised in taxes, and as a result of that, real interest rates climbed.

Senator SYMMS. But hasn't there been a massive investment in the capital base in the United States in the last 10 years? Where did the money come from, for example, to build the Saturn plant in Tennessee?

Mr. BURTLESS. If you look at what happened to gross investment, gross investment rose some, the increase entirely financed with borrowed money from abroad. But net investment has declined in the United States as a share of national income. The 1980's was the lowest decade in the postwar period. I mean, you are probably right that giving tax inducements helps spur on extra investment, but the higher borrowing costs apparently offset that.

Senator SIMON. The red light is on; if the Senator could conclude.

Senator SYMMS. I just had one last question, Mr. Chairman, so I guess you'll have to wait, Mr. Kosters, for the next round. I know you are disappointed.

Senator SIMON. I'm going to go to Senator Grassley next, but just a quick comment and question of Mr. McIntyre. I was interested in your response on the Moynihan bill. I happen to oppose it for the very reason that you point out and for the reason that Mr. Burtless pointed out of high interest rates.

I would point out to my colleague from Idaho that I had an experience not too long ago of having two officers of Chrysler come into my office and say, "We made a tough decision to borrow almost $1 billion for a research plant; we're paying 12⅜ percent interest. One of our major competitors is Nissan of Japan, which has borrowed a similar amount, and they are paying 4½ percent interest. How do you expect us to compete?"

The reality is we have to get hold of this deficit thing and get those interest rates down, and I know you vote for my constitutional amendment for a balanced budget, but along with getting those interest rates down——

Senator SYMMS. Senator, I've got the answer for that. All we've got to do is take the difference between what is needed to run social security and the tax, as I introduced in legislation last year, and put it into supplemental savings accounts with defined benefits for the individual, and you'll have a whole mountain of money out there in the hands of the people to loan to Chrysler to lower interest rates.

Senator SIMON. I'm not going to get into that right now. I am going to just for a moment get into the equity question. Kevin Phillips—a Republican, I might add, who wrote The Politics of Rich and Poor—pointed out what is happening in the shifting of the wealth base in this country. That is not a healthy thing. We have a shrinking middle class—few people moving up, more people moving down. And I think that is one of the things that we have to keep in mind.

Mr. McIntyre, you were going to take an extra minute or two, and then I want to defer to Senator Grassley, in response to the

earlier question. But in terms of the equity situation, what is happening in our country, if I can give you a softball question?

Mr. MCINTYRE. Well, Senator, I think in the last couple of years, things are actually getting a little better. The Congress has turned itself around from the policies of the early 1980's and has said look, we cannot tolerate a country with the kinds of inequality in taxes and income that we saw develop in the first half of the 1980's. So I am encouraged that I think progress is ahead of us rather than that we are headed in the wrong direction right now.

But because of those policies of the early 1980's, rich people have seen their incomes rise and their taxes fall dramatically. And the combination of that has led to higher burdens on the rest of the American taxpayers, whose incomes have not gone up very much.

It is something that needs to be reversed. I think last year's deficit reduction bill was a step in the right direction but a small one. A lot more needs to be done, not just to deal with the budget deficit, which is very important, but also to deal with the social deficit. We need to do more for child welfare, education, all the things we are talking about here that would help productivity in the long run.

We tried the experiment with giving away money to tax shelter promoters. I think it is time to try and experiment with putting some money into education and child welfare.

Senator SIMON. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. Burtless, this would be the main point that I would want to make with you today, but the discussion you had with Senator Sasser where you talked about women in high income families working in the work force—I don't know whether that was meant to be made as a negative sort of thing happening in our society, but it seems to me that this would be very positive—women becoming more affluent, making higher wages—and that we ought to welcome that sort of trend in our work force.

Mr. BURTLESS. I do. I was trying to state what has happened as neutrally as possible. I don't want to be inflammatory. I simply want to describe what has gone on.

Senator GRASSLEY. OK. But you do see that as a positive.

Mr. BURTLESS. Yes, my wife works, and I think that is positive.

Senator GRASSLEY. But there can't really be anything negative coming out of that; even if it does enhance the incomes of certain families to a greater extent, we have to welcome that sort of thing, right? Otherwise, if you are going to tax that, that is going to be discouragement to those families. You eventually reach the point of why have two spouses in the family working. So if you have a tax policy that dictates against that, then that detracts from other social goals we are trying to accomplish.

Mr. BURTLESS. I think you are absolutely right, and I think it is positive development—I welcome it—but it can have an unfortunate consequence for those people who care about the unequal capacity of some families to care for their children. My family and perhaps your family, where there is a working spouse, if you have one, can much more generously rear our children; other kinds of families which don't have this capacity to have this boost in their earnings because the wife joins the labor force at a high wage,

their children will have relatively less, and that certainly is a down side.

Senator GRASSLEY. Thank you. My second point would also deal with something you touched on before. The reason I am asking the question is I think Mr. Kosters does a good job of responding to this, and I guess I want to have you as you answer the question—which I don't think you did in the first case—reflect on Mr. Kosters' statement. But this is where you compared income trends from the 1950's through the 1980's and concluded that income rose less for families near the middle levels in the 1980's. So rather than focusing upon one slice of the pie, such as income, I want to ask you why you have not compared total compensation. We all know that employee benefits have grown as much or more than income in the 1980's—in fact, for many workers, benefits and job security are more important than increased wages. So it seems to me that unless total compensation is somehow compared, we are left with an incomplete and very misleading picture. I think Mr. Kosters filled that in, and so you must have a disagreement with him on that.

Mr. BURTLESS. Well, I do agree that it is useful to look at lots of different statistics, but I mentioned earlier that compensation measures what your employer pays for an hour of your work. It doesn't measure what you receive in real purchasing power from that pay. One of the big sources of the gain in compensation is that employers are paying higher payroll taxes. The higher payroll taxes do not result in higher living standards for the workers; they keep social security going, they keep medicare going, they pay for higher medical care costs and so on.

Second, lots of the increase in compensation in recent years has been in the form of health benefits. I don't think anyone would disagree with the proposition that they are more costly, but many people would disagree that workers as a result are receiving better medical care from them. The cost is going up, but that does not result in better health protection for workers. In fact, a typical pattern in this country is that to be able to afford a health plan, employers have been scaling back on the benefits that workers can receive.

Senator SIMON. I think I'd like to hear from Mr. Kosters if you have any response to the comment just made, because I was really taking off from a point you had made.

Mr. KOSTERS. Let me respond very briefly, Senator. There are really two classes of nonwage benefits that are part of total compensation. One is those that are voluntarily agreed to between the employer and the employee, and the other is those that are required by legislation. It seems to me that when nonwage benefits are voluntarily agreed to, mutually satisfactory to both, these nonwage benefits must be worthwhile to the employee; otherwise he would prefer to take their costs in cash wages and a different arrangement would be made. Therefore, it seems to me that those benefits must be worth what they cost to the employer; otherwise the worker would take it in wages. There is often a tax wedge involved, of course, but aside from that, this presumption seems reasonable.

Now, with regard to those that are required by legislation, it seems to me if they are not worth what they cost, then our political leadership ought to remove such requirements. And it seems to me that these considerations raise questions about the notion that these nonwage benefits are not worth what they cost.

Senator GRASSLEY. Thank you.

May I have just 5 more minutes, Mr. Chairman. I know you probably want to get to an airplane.

Senator SIMON. You go right ahead.

Senator GRASSLEY. Thank you.

Mr. Kosters, referring to a statement that Senator Riegle made that there has been a great shift toward debt financing, that the Japanese have put more equity capital in their system than we have, and the charge has been made that the tax code has helped cause this, now, Senator Riegle did not mention the capital gains tax but I want to bring that up. What effect has the 1986 change in capital gains treatment had on the shift away from equity to debt? I guess it would be my view that the repeal of the capital gains exclusion made it more attractive to debt finance rather than equity finance. I don't expect you to agree with that, but I'd appreciate your comment on it.

Mr. KOSTERS. I want to be cautious about what I say about Senator Reigle's ideas about taxes. I do believe that we have favored debt financing relative to equity financing. I agree too that the 1986 reforms shifted the balance farther in favor of debt financing because the capital gains differential was removed. Many economists have also favored some form of tax integration that would remove double-taxation of dividends to shift that balance toward equity financing.

With regard to differences between the Japanese and ourselves, the Japanese situation has been changing quite rapidly with declining property values and the like, and they are experiencing some of the same symptoms in some of their financial institutions that we have seen in our own.

With regard to capital gains taxation, I think some change ought to be considered, not necessarily a special lower rate, but perhaps some form of partial indexation or something of that sort. Since the early 1980's, we have removed a lot of tax advantages from property ownership. Some of them, perhaps should not have been put there in the first place but I think we removed too many too quickly. The result, in part, has been that we are paying more as taxpayers for salvaging financial institutions than we would otherwise need to.

Senator GRASSLEY. Thank you.

And Mr. Burtless, I want to refer to just one sentence out of your statement. "Labor market positions could be improved if the economy produced more, not fewer, jobs requiring limited skill." This takes me back to the accusations that have been made since the early 1980's that most of the jobs created in our market have been McDonald's-type minimum wage jobs rather than higher-paying manufacturing jobs. And I happen to think that that is misleading. But I think your statement would argue that we need more jobs for unskilled workers. So I'd like to have you explain this, because if you are right then these critics seem to be attacking not only a

misconception, but they are attacking jobs that in the long term tremendously help the labor market.

Mr. BURTLESS. Well, you know, that comment that I made to journalists was partly humorously intended to suggest to them that they have the world turned upside-down. It is not that the economy is producing way too many lousy jobs and bad jobs that is the problem judging by all the evidence that we have about the earnings distribution. Because if the economy indeed were producing all of these lousy jobs, the employers who were offering them would be bidding up the wages to the less skilled workers.

What I think we have instead is a situation where employers are changing the skill requirements that they have for their work force, so it is twisting the job distribution toward more highly skilled, and labor force skills are not keeping up. That is I think the critical problem. The skills of the work force are improving but more slowly in the 1980's than they did in the 1970's and in the 1960's and in the 1950's, and yet the demand of employers for a more highly skilled work force seems to be continuing to rise.

So it was partly an ironical statement. I would much prefer that we improve the skills of the less skilled to creating more lousy jobs.

Senator GRASSLEY. I thank you for your patience, Mr. Chairman, as well as the witnesses.

Senator SIMON. Thank you, and we thank our witnesses.

The hearing stands adjourned.

[Whereupon, at 12:07 p.m., the committee was adjourned.]

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